Decision 93367 AUG 4 1981

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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| In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California. | Application 59849 (Filed August 1, 1980; amended August 28, 1980 and October 14, 1980) |
| In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California. | Application 59269 (Filed November 13, 1979; amended November 15, 1979) |
| Re Advice Letter (PT&T) No. 13640 to reprice certain telephone terminal equipment and Resolution No. T-10292 granting approval of said changes. | Application 59858 (Filed August 1, 1980) |
| In the Matter of Advice Letter Filing No. 13641 of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY for authority to increase certain rates for key telephone service by $30.1 million. | Application 59888 (Filed August 19, 1980) |

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| Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto. | OII 63<br>(Filed December 18, 1979) |
| Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto. | OII 81<br>(Filed August 19, 1980) |

(Appearances listed in Appendix A.)

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I N D E X (Contd.)

# INDEX (Contd.)

INTERIM OPINION

On June 2, 1980 The Pacific Telephone and Telegraph Company (Pacific) in compliance with the requirements of Resolution M-4706 and the Commission's Regulatory Lag Plan filed its Notice of Intent (NOI) 23 to apply for a general rate increase. On August 1, 1980, Pacific filed for the increase in the amount of $794 million per year; the request was subsequently amended on the record to $790 million. Other minor amendments were made on August 28, 1980 and October 14, 1980.

By Decision (D.) 91495 dated April 2, 1980 in Application (A.) 59269 and Order Instituting Investigation (OII) 63, Pacific received an interim increase of $227.2 million based on a 1980 test year. Pacific had requested $336.9 million. That increase was made subject to review, and possible refund, in Pacific's next general rate case, the application at hand. On July 7, 1980, the administrative law judge (ALJ) assigned to this proceeding issued a ruling consolidating A.59269 and OII 63 with NOI 23 for further hearing under the Regulatory Lag Plan procedure. The result is that A.59269, OII 63, and A.59849 were consolidated for hearing.

On August 19, 1980 the Commission, on its own motion, instituted OII 81, an investigation into Pacific's operations and those of all other telephone companies in California; those companies are known as the "independents", that is, non-Bell companies. That investigation was generally for the purpose of investigating the rates, tolls, rules, charges, operations, costs, separations, intercompany settlements, practices, contracts, service, and facilities of Pacific and the independents. A change in intrastate toll rates, given the uniform statewide toll schedule, affects the earnings of the independents.

On July 31, 1980 Pacific filed A.59855 requesting an order relieving Pacific from the requirement that it implement a teleprocessing system for service representatives by December 31, 1982 as ordered by D.90642 dated July 31, 1979 in A. 58223. That matter was consolidated for hearing with this application by ALJ ruling dated October 1, 1980, heard, disposed of by D.93191 issued June 16, 1981, and is no longer a part of this proceeding.

On July 29, 1980, by Resolution T-10292, we granted Pacific's Advice Letter 13641 which was presumably filed under authority granted by D.91495 and was a request to increase key telephone service (KTS) rates by about $30.1 million annually based on estimated 1980 levels. On August 1, 1980 California Interconnect Association (CIA) filed A.59858 and on August 19, 1980 the City and County of San Francisco (San Francisco) and the City of San Diego (San Diego) filed A.59888 for rehearing and stay of Resolution T-10292. On November 4, 1980 by D.92408 the Commission granted rehearing which was held on a consolidated record with these proceedings. The ALJ bifurcated the matter into legal issues and reasonableness of rates. By D.92542 dated December 16, 1980 the Commission disposed of the legal issue by rescinding Resolution T-10292. The issue of the reasonableness of KTS rates remains to be considered by this decision.

For reference purposes a history of Pacific's major formal rate proceedings before the Commission is included as Appendix B.

These proceedings were assigned to Commissioner Leonard M. Grimes, Jr. and ALJ Albert C. Porter. Three prehearing conferences and 84 days of formal hearing were held between August 8, 1980 and April 9, 1981. Testimony was received from 85 witnesses and statements were made by numerous members of the public. 362 exhibits were received into evidence. Parties filed concurrent briefs on May 4, 1981; oral replies to the briefs were made before Commissioner Grimes and ALJ Porter on May 12, 1981; and oral argument was held before the Commission en banc on June 30, 1981.

Decision Summary

This decision, based on evidence developed during 86 days of public hearing, approves rates and charges designed to increase the annual revenues of Pacific Telephone by $610.1 million. The company sought increases totaling $790 million per year.

The Commission concludes that rates established in this decision are necessary for Pacific to provide the quality of service its customers expect. Rapid population growth in the parts of California served by Pacific has strained the company's finances. To provide adequate service to both its old and its new customers requires that Pacific have a modern, well-maintained telephone network. Yet, Pacific's modernization lags behind other Bell System companies in some important aspects.

To meet its modernization needs, Pacific will invest more than $2.9 billion per year in 1981 and 1982. This plant improvement, at the rate of more than $240 million per month, is necessary to maintain adequate service. Some of this money will be generated from the company's internal revenues but much of it will have to come from additional capital investment. Only if the company has satisfactory revenues can it finance the needed modernization. To assure Pacific the ability to attract the capital it needs, at the lowest possible cost, the decision authorizes Pacific to earn a return on common equity of 17.4 percent. This will result in an overall rate of return on total invested capital of 12.91%.

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Adopted Rate of Return
Test Year 1981

| Component | Ratio | Cost | Weighted Cost | Times Interest Coverage |
|---|---|---|---|---|
| Long Term Debt | 53.29% | 9.87% | 5.26% | |
| Preferred Stock | 5.17 | 8.08 | .42 | |
| Common Equity | 41.54 | 17.4 | 7.23 | |
| Total | 100.00 | | 12.91 | 2.45 |

Changes in Rates. The principal changes in telephone rates are these: Residential customers in the metropolitan areas of

San Francisco-Oakland and Los Angeles will have their rates for one-party, flat-rate service rise from $6 to $7 for unlimited local calls. In other parts of Pacific's territory the rates will rise from $5.70 to $6.70. These changes will affect 87 percent of Pacific's residential customers. There will be no changes in the rates for lifeline telephone service, which provides for a certain number of local calls at a fixed, low rate.

Rates per minute of measured service are not increased in order to encourage customers to move from flat-rate to measured service thereby promoting the Commission's ultimate aim of having charges for phone service relate to actual use. Because many customers who now have flat-rate service may find it economical to change to measured-rate service, the decision orders Pacific to waive its usual $22 charge for such changes for 90 days. The decision also orders Pacific to tell its residential customers of the types of services and rates available, and that they can switch for 90 days at no charge.

The message allowance for one-party measured business service is eliminated, measured residential service is not increased, flat rate foreign exchange service is frozen to that already in service with no new additions allowed where measured service is offered. Single message rate timing will be expanded, expansion of measured services for businesses will be studied, and introduction of ZUM calling will be considered for additional areas.

Most business customers with measured-rate service will find their bills increased because the free message allowance is eliminated by the order. The present monthly rate is $7, with an allowance of $4 worth of local, measured-rate calls. The monthly rate will remain at $7, but the allowance will be discontinued and each call will be billed at the measured rate.

The cost of long-distance calls within California will be increased. For example, a daytime, three-minute call from San Francisco to Los Angeles will be increased from the present $1.30 to $1.52. The present discounts of 30% for evening calls, and 60% for night and weekend calls, will not be changed.

Deregulation Issues. The decision reflects the changes in the Bell System that will occur as the result of actions by the Federal Communications Commission. The FCC has determined that, effective on March 1, 1982, the Bell System is to establish a fully separated subsidiary that will not be regulated by any government agency. This subsidiary will be responsible for, among other things, the sale of new telephone terminal equipment.

Sale of Terminal Equipment. To protect ratepayers during the transition period to deregulation, and to aid the company's financial position, the decision orders the company to present by September 15 a plan under which Pacific will offer to sell all terminal equipment, business and residential, to present customers. Once the plan has been submitted, hearings will be held on it. In the interim, monthly telephone rental reates will be increased. Rates for the basic rotary-dial telephone will be increased from the present 60 cents to $1. Touchtone rates will be increased from $1.10 to $1.55. Sale of terminal equipment would eliminate the impact of these increases.

Migration Strategy. Several intervenors charged that AT&T and Pacific are engaged in a deliberate attempt to force business customers with older equipment into installing the newest type of equipment offered by the Bell System under long-term contract, in an attempt to lock out equipment of telephone system competitors. During the hearings this was referred to as the "installed base migration strategy." Although Pacific denied the allegations, the decision concludes that the evidence is persuasive that Pacific adopted the migration strategy but not directly its pricing concepts, which were designed to price old equipment so that it could not be economically compared to new equipment.

Intervenors charged that Pacific deliberately manipulated costing procedures to dovetail with the migration strategy to reprice old business equipment out of the market. The intervenors claimed that Pacific's purpose in doing this is to accomplish post-deregulation market positioning which could leave the remaining customers of regulated services with stranded investment to pay off. Accordingly, the decision does not authorize any increases in business terminal equipment charges except for a 5.4% increase added to all equipment charges across the board as necessitated by the overall rate increase.

Unregulated Subsidiary. The decision ensures that the ratepayers of Pacific's regulated operations will pay for only those expenses and investment attributable to regulated services. Over $19 million in start-up costs for deregulated activities were deleted from 1981 expense estimates on the recommendation of the staff. Further hearings will be held to determine proper costing techniques for ratemaking, the amount and disposition of any stranded investment, and accounting for expenses associated with establishing unregulated operations. Pacific's management will be held responsible to the ratepayers to assure it recovers all expenses for and investment in unregulated operations once these have been finally determined.

The net effect of the authorized rates on a typical residential customer in the ZUM areas with individual line service and rotary dial set would be an increase of approximately 17.9% based on the following components.

| | Present Rate | Authorized Rate |
|---|---|---|
| Monthly Line Rate | $ 6.00 | $ 7.00 |
| Station Set (Rotary Dial) | .60 | 1.00 |
| ZUM Charges | 3.00 | 3.25 |
| Toll Charges | 15.00 | 16.90 |
| Other Service and Equipment | 1.40 | 1.45 |
| Prop. 13 Credit | -.89 | - |
| | 25.11 | 29.60 |

Present rates include a total $197 million interim increase granted in April 1980 which this decision continues.

In general, The Commission found that Pacific is doing a good job of serving the public. There were several isolated areas of service problems brought out that will be or have been dealt with such as service to the alarm industry and services in some southern California areas.

The long history of income tax problems of Pacific and the Commission concerning accelerated depreciation allowances for tax purposes surfaced again in this proceeding, and the Commission finds that given the options available to it Pacific has not thus far acted in bad faith in its efforts to resolve the problem since the last Commission decision.

Investigation into the policies and practices of Pacific in its dealings with minorities and women in both services and the procurement of goods, affirmative action in employment, and in the provision of bi-lingual telephone services will be decided at a later date.

## Background of Pacific

Pacific is one of 21 principal telephone operating subsidiaries (OTCs) of American Telephone and Telegraph Company (AT&T). AT&T also owns Western Electric Company, Inc. (Western Electric or Western), which manufactures and installs equipment for AT&T and the OTCs, and the 195 Broadway Corporation (195), which provides office space and services to AT&T. AT&T and Western each own 50% of Bell Telephone Laboratories, Inc. (Bell Labs), which is the Bell System's research and development arm. AT&T, Western, Bell Labs, and the OTCs form what is known as the Bell System.1/

As of December 31, 1979 AT&T owned almost 90% of the voting securities of Pacific, 90.8% of the common stock, and 78.2% of the preferred stock. Holders of Pacific's common stock at December 31, 1979 totaled 65,719; following are the number of shares held at that time by the 10 largest.2/

| | | |
|---|---|---|
| 1. | American Telephone & Telegraph Company | 152,036,157 |
| 2. | Merrill Lynch, Pierce, Fenner & Smith, Inc. | 474,871 |
| 3. | Pacific & Company | 387,266 |
| 4. | E. F. Hutton & Company | 117,072 |
| 5. | Shearson Loeb Rhoades | 79,825 |
| 6. | Paine, Webber, Jackson & Curtis, Inc. | 78,747 |
| 7. | Wells Fargo Bank, N.A. | 77,674 |
| 8. | Kray & Company | 75,376 |
| 9. | First Jersey National Bank | 60,486 |
| 10. | Pacific Securities Depositaries | 57,330 |
| | Total | 153,444,804 |

1/ The relationships of these various entities are fully explained under the discussion of license contract expenses which follows. (See Diagram A.)

2/ Holders 2 through 10 would appear to be acting as depositaries for clients.

Pacific operates in California and Nevada and has one subsidiary, Bell Telephone Company of Nevada (Nevada) which renders telephone service only within that state. All of the outstanding stock of Nevada is owned by Pacific. The only counties in California not served by Pacific are Mono, Alpine, Lassen, Modoc, Del Norte, and Santa Barbara. Pacific estimates that it serves over 78% of California's total population.

At the end of 1979 Pacific's total telephone plant in service amounted to more than $13 billion and it had almost 16 million telephones in service. The cost of telephone plant in service at the end of 1981 is estimated to be more than $17 billion; telephones in service will be more than 17 million. As of September 30, 1980 there were 6,761,000 residential and 826,000 business customers.

Pacific estimates that in 1979 there were more than 26 billion local telephone calls made from telephones in its service area, an average of more than 1,700 per telephone. Pacific expects it will have 117,000 employees by the end of 1981.

In this decision there will be references to total operations and California intrastate operations. The total operations include California intrastate and the interstate business done within California but not the Nevada subsidiary. The rates under jurisdiction of this Commission include only those which are assessed for intrastate telephone service in California. Attached, as Appendix C, are some data on Pacific's operations for the years 1970 through 1981 estimated.

Participating Parties

As can be seen from the appearance list, Appendix A, more than 30 parties appeared in these proceedings. Although the reference name for a party is shown in parentheses when the party is first identified in this decision, this list is for the convenience of the reader.

Pacific or PT&T

The Pacific Telephone and Telegraph Company, the applicant.

Staff

The Public Utilities Commission technical and legal staff.

Continental

Continental Telephone Company of California.

General or GTE

General Telephone Company of California.

TASC

Telephone Answering Services of California.

CHMA

California Hotel and Motel Association.

Users Group

California Retailers Association, Tele-Communications Association, American Broadcasting Companies, Inc., and CBS, Inc.

Delphi

Delphi Corporation.

GSA

General Services Administration for Executive Agencies of the United States.

WBFA

Western Burglar and Fire Alarm Association.

Los Angeles

City of Los Angeles.

<u>San Francisco</u>

City and County of San Francisco.

<u>San Diego</u>

City of San Diego.

<u>LA County</u>

County of Los Angeles.

<u>Sonitrol</u>

Sonitrol Telephone Assistance.

Summary of Issues

The following is a summary of the major issues in this proceeding:[3/]

Revenues. Pacific's estimate is $164.4 million above the staff estimate for 1981. The staff estimate adjusted downward by $54 million is adopted.

Expenses. Pacific and the staff differ by $280 million on expense estimates for 1981. The staff estimate, which is lower, is adopted with some major adjustments for maintenance, commercial, and general office expenses.

License Contract/Affiliate Adjustments. Pacific and the staff differ by $33 million on the license contract adjustment. $19 million of this is due to staff's estimate of expenses attributable to deregulation activities. Staff's estimate is adopted with minor adjustments. Other issues involve product-related disallowances to Western, Bell Labs business information systems, and the Western Electric adjustment. With minor exceptions staff's recommendations are adopted.

Rate Base. Pacific is $419 million (out of about $12 billion) higher than staff. The difference is primarily due to estimates of plant-in-service, working cash, and material and supplies. With some exceptions the staff estimates are adopted.

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3/ Unless indicated otherwise, figures shown relate to Pacific's total California operations under present rates.

Construction Work in Progress (CWIP). Pacific requests CWIP be included in rate base which is not adopted. Interest on CWIP will be compounded monthly instead of semiannually.

Rate of Return. Recommendations range from 10.20% to 13.47%. 12.91% is adopted, providing 17.4% on equity.

Service. WBFA makes valid accusations of poor service. Committee will be formed to recommend standards.

Migration Strategy. Several intervenors charge AT&T and Pacific are engaged in a deliberate attempt to force customers with older equipment into installing new flagship equipment under long-term contract in order to lock out equipment of telephone company competitors. Although Pacific denies the allegations, the evidence is persuasive that Pacific adopted the migration strategy but not directly its pricing concepts, which were designed to price old equipment so that it could not be economically compared to new equipment.

Costs for Ratemaking. Intervenors charged that Pacific deliberately manipulated costing procedures to dovetail with the migration strategy to reprice old equipment out of the market. Valid points were raised about the costing techniques and further hearings will be held to review the procedures.

Phasing in Increases. Terminal equipment users complained that increases proposed were too severe, some ranged up to several times the present rates. The Commission will move as quickly as possible to cost-based rates but revert to its former policy of increases no greater than about 50% per year.

Mobile Telephone Rates. Intervenors charged Pacific's mobile telephone rates are noncompensatory and radiotelephone utilities competing with Pacific suffer as a result. Pacific and Allied Telephone Companies Association, which represents the majority of radiotelephone utilities, stipulated to actions to remedy the situation.

Staff's Audit Report Recommendations. Pacific took exception to many of the staff's recommendations. The decision rejects some and adopts some.

Sale of Equipment. Staff and intervenors recommend Pacific file tariffs for sale of equipment to users. The decision adopts the idea with further hearings to be held to work out details.

Accelerated Depreciation. Intervenors and staff questioned whether Pacific has acted in good faith to preserve its eligibility to use accelerated depreciation under ratemaking concepts adopted by the Commission.

Allowance for Attrition. Pacific requests an allowance for diminution of earnings because of increased expenses, higher cost of debt, and wage increases. The decision denies this request.

1981 Estimated Results of
Operations - Present Rates

Pacific and the staff were the only parties to the proceeding to offer complete estimates of results of operations for the rate year 1981. Tables 1 and 2 are a summary of the results of operations by Pacific and the staff for total company operations (Table 1) and California intrastate operations (Table 2) under present rates. The detail of the estimates is shown in Appendix D. Because the estimated results of operations by the staff are based on later data than those of Pacific and, for the most part, are concurred in by Pacific, we will accept the staff's results of operations except as noted in the following sections of this decision. The estimated results of operations for 1981 we will adopt are shown on Table 25 and in Appendix D.

It is noted that, in general, the discussions of revenues, expenses, and rate base are based on Pacific and staff forecasts of Pacific's total California operations which include interstate and intrastate operations. The evidence on individual items was analyzed primarily for both Pacific and staff on that basis.

TABLE 1

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Results of Total California Operations
Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff |
|---|---|---|---|
| Operating Revenues | $ 6,380,016 | $ 6,544,368 | $ 164,352 |
| Operating Expenses & Taxes | | | |
| Current Maintenance | 1,569,530 | 1,705,134 | 135,604 |
| Depreciation & Amortization | 852,566 | 896,221 | 43,655 |
| Traffic Expenses | 406,256 | 417,822 | 11,566 |
| Commercial Expenses | 706,121 | 730,766 | 24,645 |
| Gen. Office Salaries & Expenses | 355,621 | 371,513 | 15,892 |
| Operating Rents | 51,889 | 54,412 | 2,523 |
| Gen. Services & Licenses | 55,515 | 88,355 | 32,840 |
| Balance Other Oper. Expenses | 567,628 | 669,116 | 101,488 |
| Total Oper. Expenses | 4,565,126 | 4,933,339 | 368,213 |
| Operating Taxes-Federal Income | 300,436 | 186,124 | (114,312) |
| Cal. Corp. Franch. | 52,198 | 65,635 | 13,437 |
| Social Security | 132,305 | 138,882 | 6,577 |
| Other | 130,488 | 136,897 | 6,409 |
| Total Expenses & Taxes | 5,180,553 | 5,460,877 | 280,324 |
| Net Revenues | 1,199,463 | 1,083,491 | (115,972) |
| Avg. Net Plant & Working Capital | | | |
| Telephone Plant-in-Service | 15,683,907 | 16,008,289 | 324,382 |
| Telephone Plant Under Constr. | | | |
| Property Held for Fut. Tel. Use | 2,910 | 2,910 | 0 |
| Telephone Plant Acquisition Adj. | | | |
| Working Cash Allowance | 228,165 | 303,178 | 75,013 |
| Material and Supplies | 130,678 | 149,946 | 19,268 |
| Less: Depreciation Reserve | 2,934,645 | 2,924,140 | (10,505) |
| Less: Reserve for Deferred Taxes | 1,485,707 | 1,495,377 | 9,670 |
| Total Rate Base | 11,625,308 | 12,044,806 | 419,498 |
| Rate of Return | 10.32% | 9.00% | (1.32)% |

(Red Figure)

Separations and Settlements

Most of the telephone utility plant of Pacific is physically located within California. Major portions of the plant as well as associated expenses, reserves, and taxes involve both intrastate and interstate operations. Intrastate services are regulated by this Commission and interstate services by the Federal Communications Commission (FCC). Some parts of the system are used for intrastate service only and therefore can be assigned directly to intrastate; other portions used exclusively for interstate can be assigned directly to interstate. But, the major portion is used for both services and therefore, for ratemaking purposes, must be separated or allocated between jurisdictions. This process requires the allocation of revenues, expenses, taxes, investments, and reserves.

In addition, the provision of intrastate and/or interstate services often involves the use of more than one company's facilities. For example, a call between San Francisco and Santa Monica involves facilities of both Pacific and General Telephone; an interstate call could easily involve use of the facilities of two or even three companies. In these cases the costs of each of the utilities must be determined to permit a division of the revenues. This process is called settlements and its methods parallel separation procedures.

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

The basic principles and procedures currently used in making separation studies are contained in the separations manual published in 1971 by the National Association of Regulatory Utility Commissioners (NARUC) and adopted by the FCC effective January 1, 1971. This is commonly referred to as the Ozark Plan. The first separations manual was issued in 1947 and has since been revised many times.

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

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

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

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

It is of interest that as recently as 1979 the Commission in D.90861 addressed some particular problems concerning separations and the solutions are still being pursued in pending Case (C.) 10948 concerning the proposed exchange access charge tariff.

Intrastate Results - Present Rates

Table 2 represents Pacific and staff estimated 1981 results of operations under present rates for the intrastate service in California separated and allocated from the total company operations shown on Table 1. This is the table we will use as a starting point for determining the additional revenue requirement to bring Pacific's earnings to the rate of return we find reasonable for this decision.

Pacific's estimate would produce a return of 8.68% on a rate base of $9.061 billion. This is 4.79 percentage points below the 13.47% overall return requested by Pacific. 4.79% times Pacific's $9.060 billion rate base would require a net increase of $433,974,000. Applying to that Pacific's net-to-gross multiplier[4/] of 1.902, the gross revenue increase required would be $825,419,000.

The staff's test year return of 9.91% under present rates is 1.59 points below its recommended 11.50% return. Applying 1.59% to its rate base of $8.677 billion the staff's requirement would be a

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4/ The net-to-gross multiplier accounts for the increased income taxes on increased before-tax net revenues. For example, under Pacific's calculations it takes a $1.902 increase in revenues to produce $1.00 after taxes.

net increase of $137,964,000. Applying the staff's net-to-gross multiplier of 1.896 to that would require a total gross revenue increase of $261,580,000.

As can be noted on Table 2, the staff is $100,000,000 below Pacific in its revenue estimate and $174,000,000 below in its expense estimate for a net difference of $74,000,000. The staff is also 4% below Pacific in its rate base estimate. Those differences aside, the main reason for the large difference in the net revenue increase requirements is the rate of return recommendations; that difference is, in turn, based on the recommended return on equity because there is no substantial dispute between Pacific and staff on the projected year-end 1981 capitalization ratios and cost of debt and preferred stock.

TABLE 2

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Results of California Intrastate Operations
Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff |
|---|---|---|---|
| Operating Revenues | | | |
| Local Service Revenues | $2,375,863 | $2,452,050 | $ 76,187 |
| Toll Service Revenues | 2,079,818 | 2,130,704 | 50,886 |
| Miscellaneous Revenues | 339,800 | 323,646 | (16,154) |
| Uncollectibles | (51,177) | (62,042) | (10,865) |
| Total | 4,744,304 | 4,844,358 | 100,054 |
| Operating Expenses & Taxes | | | |
| Current Maintenance | 1,135,282 | 1,227,407 | 92,125 |
| Depreciation & Amortization | 639,510 | 672,897 | 33,387 |
| Traffic Expenses | 318,625 | 328,963 | 10,338 |
| Commercial Expenses | 582,375 | 607,042 | 24,667 |
| Gen. Office Salaries & Expenses | 278,569 | 287,844 | 9,275 |
| Operating Rents | 41,553 | 42,105 | 552 |
| Gen. Services & Licenses | 41,514 | 66,072 | 24,558 |
| Balance Other Oper. Expenses | 428,826 | 498,674 | 69,848 |
| Total Oper. Expenses | 3,466,254 | 3,731,004 | 264,750 |
| Operating Taxes-Federal Income | 192,087 | 111,850 | (80,237) |
| Cal. Corp. Franch. | 28,460 | 9,363 | (19,097) |
| Social Security | 100,065 | 103,507 | 3,442 |
| Other | 97,579 | 102,362 | 4,783 |
| Total Expenses & Taxes | 3,884,445 | 4,058,086 | 173,641 |
| Net Revenues | 859,859 | 786,272 | (73,587) |
| Avg. Net Plant & Working Capital | | | |
| Telephone Plant-in-Service | 11,728,426 | 11,987,458 | 259,032 |
| Telephone Plant Under Constr. | | | |
| Property Held for Fut. Tel. Use | 2,180 | 2,227 | 47 |
| Telephone Plant Acquisition Adj. | | | |
| Working Cash Allowance | 173,250 | 229,631 | 56,381 |
| Material and Supplies | 97,643 | 113,021 | 15,378 |
| Less: Depreciation Reserve | 2,206,853 | 2,164,230 | (42,623) |
| Less: Reserve for Deferred Taxes | 1,116,657 | 1,107,460 | (9,197) |
| Total Rate Base | 8,677,989 | 9,060,647 | 382,658 |
| Rate of Return | 9.91% | 8.68% | (1.23)% |

(Red Figure)

Operating Revenues - 1981 -
Present Rates

Table 3 sets forth the estimated operating revenues by Pacific and the staff for the test year 1981 under present rates. The staff's estimate for total revenues before adjustments is $176.6 million less than Pacific's. With two exceptions Pacific accepts the lower estimates of the various revenue subcategories. The main revenue issue between the staff and Pacific is intrastate toll. The staff's $48 million lesser estimate is based on later data than were available when Pacific made its estimates; Pacific believes it should be even lower than it is because the staff was able to review actual revenue data through the summer of 1980. Those data fell below Pacific's earlier forecasts; later Pacific estimates for 1981 were even lower. Pacific claims the staff accepted, in many cases, the post-NOI Pacific estimates; but for the Intrastate Message Toll Service (MTS) and Wide Area Telephone Service (WATS) forecasts, the staff ignored the actual data as well as the revised forecast that were supplied. Pacific claims the staff was inconsistent when considering later information by accepting some and rejecting other, while at the same time ignoring a decrease of $108 million in the revised forecast of intrastate MTS and WATS billings. Therefore, Pacific believes the staff's figures for the intrastate MTS and WATS billing should be decreased by $108 million and the effect flowed through to net intrastate toll service revenues.

We are not totally convinced by either the staff or Pacific on this issue. Therefore, we will decrease the staff's estimate by one-half of the $108 million or $54 million.

One issue brought up on cross-examination of the staff concerns the revenue estimate for service connection charges. The staff estimate for this revenue is about $63,725,000 lower than Pacific's. This is most of the $68.8 million difference shown for Account 500, Table 3. The staff estimate includes the impact of phone centers on service connection charges and the estimate of Pacific does not. The staff was cross-examined on whether it made a related reduction in investment estimates to reflect service connection changes which would not have to be made because of customers' picking up phones from phone centers and installing them themselves. Although the staff testimony is not completely clear on this issue, the staff claimed its estimate of plant includes the effect of the reduction in installations. We adopt their position.

As a result of D.91495 dated April 2, 1980, Pacific put rates into effect based on test year 1980 which were anticipated to result in a yearly revenue increase of $227 million. As noted previously, D.92542 dated December 16, 1980, rescinded a yearly increase based on 1980 of $31 million on KTS rates, thus reducing the $227 million to $196 million. Pacific believes that because the rate increase in A.59849 is premised on an existing level of rates inclusive of the full $227 million, the final revenue requirement should incorporate the $31 million. To illustrate Pacific's position further, by A.59849, it is asking for about $790 million additional revenues over and above the $227 million granted by D.91495. This would total $1.017 billion; but because the $227 million was reduced by $31 million, Pacific claims it should be granted $821 million in this proceeding. ($790 plus $31.)

However, as can be noted on Table 3, $32,652,000 has been deducted from both Pacific's and staff's estimates of revenue under present rates, the $32,652,000 being the level of the KTS increase for 1981 that was included in both original estimates. Therefore, the results of operations in Table 1 already include the KTS adjustment. All that remains to be done then is to determine the revenue requirement necessary to produce results of operations reflecting the expenses, rate base, and rate of return we adopt for 1981 and the matter is taken care of. The reasonableness of KTS rates will be addressed in the section on the rate design required for the revenue requirement.

TABLE 3

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Total Operating Revenues - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| | Local Service Revenues | | | | |
| 500 | Subscriber Station Rev. | $2,123,199 | $2,191,950 | $ 68,751 | $2,123,200 |
| 501 | Public Telephone Rev. | 56,000 | 63,517 | 7,517 | 56,000 |
| 503 | Service Stations | 250 | 276 | 26 | 300 |
| 504 | Intra. Local PL & Other | 38,580 | 38,500 | (80) | 38,600 |
| 504 | Inter. Local PL & Other | 2,280 | 2,280 | 0 | 2,300 |
| | Subtotal | 2,220,309 | 2,296,523 | 76,214 | 2,220,400 |
| | Toll Service Revenues | | | | |
| | Intrastate Toll | 2,038,028 | 2,086,155 | 48,127 | 1,984,000 |
| | Interstate Toll | 1,643,806 | 1,722,079 | 78,273 | 1,643,800 |
| | Subtotal | 3,681,834 | 3,808,234 | 126,400 | 3,627,800 |
| | Miscellaneous Revenues | | | | |
| 523 | Directory Adv. & Sales | 289,200 | 280,480 | (8,720) | 289,200 |
| | Other Miscellaneous Revs. | 50,600 | 43,166 | (7,434) | 50,600 |
| | Subtotal | 339,800 | 323,646 | (16,154) | 339,800 |
| | Total Before Uncollectibles | 6,241,943 | 6,428,403 | 186,460 | 6,188,000 |
| 530 | Uncollectible Revenues | (75,304) | (85,148) | (9,844) | (74,500) |
| | Total Before Adjustments | 6,166,639 | 6,343,255 | 176,616 | 6,113,500 |
| | Marketing & Competition | (9,300) | (9,300) | 0 | (9,300) |
| | D. 91495 (Incl. Adv. Ltr. 13641) | 243,065 | 243,065 | 0 | 243,100 |
| | FCC Decision ID No. 80-297 | 28,375 | 0 | (28,375) | 28,400 |
| | Traffic Expense Adj. | 80 | 0 | (80) | 100 |
| | Adjusted Oper. Revs. | 6,428,859 | 6,577,020 | 148,161 | 6,375,800 |
| | Tran. to Long Line Adj. | (16,191) | 0 | 16,191 | (16,200) |
| | Rescinded Advice Ltr. 13641 | (32,652) | (32,652) | 0 | (32,700) |
| | Recast Operating Revs. | 6,380,016 | 6,544,368 | 164,352 | 6,326,900 |

(Red Figure)

<u>Expenses - General</u>

Pacific's primary concern with the staff's estimates of 1981 expenses is that the staff used data from the first part of 1980 in many of its estimates; Pacific claims the first part of 1980 was affected by a constrained budget but in the latter part of 1980 budget limitations were lifted and more normal expenditures were made. However, the staff was aware of this. In Exhibit 246, Ch. 16, pp. 16-1, 2, the staff notes:

> "For 1980 the staff investigation had benefit of in excess of eight months of actual operations more than the Pacific did for the development of its showing in Application No. 59269. In this experience it also saw a change from the testimony of the utility's witness, T. J. Saenger, President and Chief Operating Officer, that the utility was planning a 'constrained' budget program for 1980 and would hold force levels to 105,500 people. The utility's 1979 Commitment Budget of its 1980 operations, slightly modified for its February view which was used as the basis for its NOI, contained increases in projections over the October 1979 view. The increased commitment budget had been developed prior to Mr. Saenger's appearance on the witness stand. As of August 31, 1980, the force level in California was 108,435 and going up."

Pacific claims that the higher level of expenses in the latter part of 1980 clearly does not support the staff's method because an underrun, that is, lower than normal expenditures, in an account during the first half of the year will not necessarily result in an underrun next year.

In general, we will accept the staff expense estimates which corresponds to our adoption of its revenue estimates thereby accepting the staff's overall view of 1981 operating levels. We will, however, make some specific adjustments to the staff estimates; these are highlighted in the discussion which follows.

Maintenance Expenses

| | |
|---|---|
| Pacific | $1,705,134,000 |
| Staff | 1,569,530,000 |
| Difference | 135,604,000 |

Maintenance is the largest category of Pacific's operating expenses. The difference for 1981 between Pacific and the staff on an estimated total California basis before adjustments is $112.8 million (see Table 4). Pacific estimated that maintenance expenses would increase about 20% in 1981 over 1980 because of increases in workload, labor costs, and targeted service improvements. Some of the increases would be partially offset by improved productivity.

TABLE 4

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Maintenance Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 602 | Repairs of Outside Plant | $ 262,300 | $ 262,300 | $ 0 | $ 262,300 |
| 603 | Test Desk Work | 250,853 | 250,853 | 0 | 250,900 |
| 604 | Repairs of Central Ofc. Equip. | 513,657 | 567,195 | 53,538 | 516,300 |
| 605 | Repairs of Station Equip. | 458,599 | 513,949 | 55,350 | 488,500 |
| 606 | Repairs of Bldgs. & Grounds | 55,088 | 56,499 | 1,411 | 55,100 |
| 610 | Maintaining Transmission Power | 31,711 | 26,043 | (5,668) | 33,900 |
| 612 | Oth. Maintenance Expense | 29,658 | 29,658 | 0 | 29,700 |
| | Subtotal Before Adjs. | 1,601,866 | 1,706,497 | 104,631 | 1,636,700 |
| | Electrical Energy Adj. | (4,400) | 0 | 4,400 | (4,400) |
| | Reduction of Construction Exp. | (3,806) | 0 | 3,806 | (3,800) |
| | Allocation of Adm. Bldgs. | (46) | (46) | 0 | - |
| | Subtotal Adjustments | (8,252) | (46) | 8,206 | (8,200) |
| | Total Maintenance Expense | 1,593,614 | 1,706,451 | 112,837 | 1,628,500 |
| | Deprec. SL-RL Adjustment | (845) | (1,317) | (472) | (800) |
| | Adjusted Maintenance Exps. | 1,592,769 | 1,705,134 | 112,365 | 1,627,700 |
| | Affiliated Int. Adj. | (14,837) | 0 | 14,837 | (7,600) |
| | Tran. to Long Line | (17,748) | 0 | 17,748 | (17,700) |
| | Wage Contract Adj. | 9,346 | 0 | (9,346) | 9,300 |
| | Recast Maintenance Exps. | 1,569,530 | 1,705,134 | 135,604 | 1,611,700 |

(Red Figure)

Pacific claims its maintenance expenditures were constrained in the first half of 1980; therefore, trends based on maintenance expense levels for 1980 cannot be used to project appropriate levels for 1981. Pacific believes the staff's estimates reflect methods which rely almost completely on what has happened in the past in order to estimate the future.

For Accounts 602, 603, 612, and the adjustment for Allocation of Administration Buildings the staff and Pacific are in agreement.

For Account 604, repairs of central office equipment, one of the largest accounts in the maintenance group, the staff estimate is $53.5 million lower than Pacific's. This account is divided into two subparts, Central Office Equipment (COE) Change, and COE Upkeep. COE Change is work done in the central offices in response to customer orders for new equipment and changes to old equipment. COE Upkeep is the normal everyday repair of central office equipment.

Pacific's estimate for COE Change is $328,931,000, which is $23,526,000 over the staff's estimate of $305,405,000. The major reasons for the difference are the estimated number of production hours and engineering, and Western Electric billing.

The staff estimate for Western Electric billing and engineering costs was $18,176,000 lower than Pacific's. Western Electric billing includes all expense billing transactions chargeable to the account between Western and Pacific. It includes material and labor, Western's service charges for handling and storage of utility material, salvage credits, and general equipment expenditures. Pacific estimates the Western Electric billing by assuming it would increase in proportion to the workload used in the calculation of labor costs times an inflation factor. The inflation factor Pacific used was 9.7%, which was higher than the 5.8% increase estimated by the

Bell System for its telephone plant index for central office equipment. Pacific developed its engineering costs in a similar manner except a wage increase factor was used instead of the 9.7% inflation factor. Staff believes the Western Electric and engineering costs are more related to Pacific's construction program for central office equipment. The staff used as a ratio the recorded 1979 Western billing plus engineering costs divided by 1979 central office equipment construction expenses. This was applied to Pacific's April 1980 view for central office equipment construction costs in 1981. The staff believes its estimate is conservative because the 1979 ratio was 12% while recorded data through June 1980 was only 10.5%. $9,336,000 of the $18,176,000 difference is due to the lower estimated central office equipment construction expense estimate for 1981. We will adopt the staff's estimate as reasonable for engineering and Western Electric billing modified to reflect the adopted rate of return for Account 604.

The remainder of the differences in COE changes, that is, $5,350,000 ($23,526,000 - $18,176,000), is due to the use of different methods by the staff and Pacific to estimate workload and productivity, the two key factors used to estimate production hours. Pacific estimated workload by assuming that special services interoffice circuit growth was a good indicator for estimating workload growth, production hours being the result of dividing workload by productivity. The staff method for estimating workload depended primarily on main and equivalent main telephones in-service and out-of-service (inward + outward) movement.5/

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5/ See Appendix E for a definition of "main and equivalent main telephones" which hereafter will be referred to as "telephones".

Both Pacific's and the staff's method seem to be reasonable for estimating the portion of COE changes attributable to production hours, even though they produce different results. Therefore, we will adjust the staff's estimate of $305,405,000 for COE changes upward by one-half of the $5,350,000 difference to a total of $308,080,000.

Pacific's estimate for COE upkeep is $238,264,000 which is $30,012,000 above the staff's estimate of $208,252,000. The major reason for this difference is again the estimate of production hours. The staff claims that it did not use Pacific's method for estimating because Pacific's system gives too much weight to rapidly growing circuits and related items. The staff claims, also, that Pacific made some mathematical mistakes in its calculations. Also, staff believes Pacific is underestimating the effects of technology. For instance the number of telephones served by electronic switching (ESS) offices has been growing rapidly The percentage for 1976 was 14.9%; 1977, 17.6%; 1978, 21.1%; 1979, 27.5%; and estimated for 1980, 35.3%, and for 1981, 43.6%. Pacific plans to spend almost $1 billion for central office equipment construction in 1981 to further increase the number of telephones served by ESS systems. The staff believes that telephones are a good plant unit or workload indicator for COE upkeep. Upkeep hours for telephones are falling at a fairly constant rate. For instance, in 1975 the COE upkeep hours per telephone were 1.144 and in 1979 that had dropped to 0.719.

Pacific believes telephones do not give proper consideration to the growth in the circuit portion of the account which is affected by increases in customer usage and high growth in special services. Pacific claims the difference in the estimates is primarily based on differences in statistics used. Pacific believes that when making its forecast for COE upkeep the staff did not test the reasonableness of its estimate of hours. It claims that a good test is to determine what productivity results when the staff's estimate for hours is divided by Pacific's forecast of work units. The staff's estimate for hours requires a productivity of 15.84 work units per hour, whereas the actual July 1980 six-month productivity figure was 12.96. However, that argument can be turned around. If the 12.96 productivity figure is applied to the 101,115,000 work units estimated by Pacific, the total hours would be 7,802,000. Table 5 shows the following for total hours for the last five years for COE upkeep.

TABLE 5

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

COE Upkeep Hours Per Main
And Equivalent Main Telephone (M+EMT)

| | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|
| Total Hours (000's) | 8,889 | 8,200 | 7,309 | 6,789 | 6,861 |
| M + EMT | 7,859,078 | 8,212,171 | 8,650,523 | 9,155,325 | 9,667,061 |
| Hours per M + EMT | 1.144 | 1.011 | 0.856 | 0.751 | 0.719 |
| % Decrease in Hours Per M + EMT | | 11.6 | 15.3 | 12.3 | 4.3 |

Source: Exhibit 246, P. 8-25.

The total hours in 1979 rose for the first time in that four-year period but it should be pointed out that if one were to look at the telephones in service for those years the 1979 increase over 1978 was enough to still reduce the hours per telephone.

The staff's estimate of 6,348,000 total hours may be tested another way. The staff's estimate for telephones in service in 1981 is 10,534,000. Dividing the 6,348,000 total hours estimated by the staff by the 10,534,000 telephones gives .603 hours per telephone. Comparing the .603 to the .719 for 1979 shows that the hours per telephone would have to decrease by 16.1% over a two-year period, about 8% per year. Comparing 1979 to 1975, the hours

Process
10

per telephone dropped from 1.144 to 0.719, 37.2% over a four-year period, or in excess of 9% per year. Using that comparison the staff's estimate looks reasonable and will be adopted.

The final estimate then that we will adopt for Account 604, Repairs to Central Office Equipment, is $516,300,000. That total is made up of $308,100,000 for COE changes and $208,200,000 for COE upkeep.

Repairs of Station Equipment

Pacific's estimate for Account 605, Repairs of Station Equipment, is $513,949,000 which exceeds staff's estimate of $458,599,000 by $55,350,000. Like Account 604, 605 is split between change and upkeep. Station changes involve work on customer requests for changes in service; upkeep involves the repair of existing station apparatus, station connections, and large private branch exchanges (PBX).

For station changes Pacific estimated $268.9 million and staff $243.5 million for a difference of $25.4 million. The major reasons for the difference in estimates are forecasts of production hours and Western Electric billing expense. The staff claims it could not accept Pacific's estimates for production hours because its estimates of complexity (work units per plant unit) and productivity (work units per hour) which, together, result in production hours, were not reasonable. The productivity for station changes had been increasing in the 1970s until 1978 and 1979 when it decreased by 4.2% and 3.1%, respectively. Pacific predicted a 2.5% increase in 1980 and a 1.1% increase in 1981. The staff noted that Pacific's estimate for productivity in 1981, 11.84 work units per hour, was still below the 12.30 level of 1977, which is the same level Pacific had achieved through June 1980 and which is 3.9% above its estimate for 1981.

The staff claimed that Pacific's complexity estimate is equally inaccurate when looking at recorded data. Part of the problem is the way Pacific estimated it. For example, the residence segment used the ratio of inward extensions to inward main stations to influence its pick, which in the staff opinion has no correlation with people exchanging or relocating their telephones. The staff used the standard load indicator, inward telephones, for station changes to estimate hours. It trended the ratio of hours per inward movement between 1975 and 1979, which has a high degree of correlation, times the staff's estimate of inward telephones for 1981.

The staff also claims Pacific overestimated its Western Electric billing by $11,506,000. Western Electric billing primarily includes the cost of shop repairs and conversions of station equipment for reuse. The staff used station growth in 1981 and a Bell system inflation factor for its estimate.

Considering the general level of business the staff has adopted, we find their estimate to be reasonable and adopt it as modified to reflect the adopted rate of return.

Station upkeep includes the cost of repairing station apparatus, station connections, and large PBXs. It also includes repairing used station equipment for reuse and repairing phone booths. Pacific's estimate for station upkeep is $245,016,000, which is $29,881,000 above the staff's estimate of $215,135,000.

Pacific takes exception to the way the staff forecasted its estimate, which was to multiply the forecasted number of trouble reports times the trended estimate of the hours per trouble report. The staff's estimate of the hours per trouble report was much lower than Pacific's, 0.650 compared to 0.776. Pacific claims it intends to bring its trouble report rates down to a lower level, claiming through its witness Short, that the 1981 needs of residential service customers cannot be met without the resources requested in Pacific's budget. He stated that a decrease in the rate of trouble reports has been accompanied by an increase in the hours per trouble report and vice versa. The staff's technique fails to consider Pacific's objectives in 1981 because the staff used Pacific's intention to reduce trouble reports per measured station, but at the same time projected a decrease in the hours per trouble report. Therefore, Pacific claims the staff's projection is the opposite of the historical relationship.

The staff disagreed with Pacific's estimate of production hours, claiming that almost all of the time spent on taking telephones apart for repair, or repairing used telephones for reuse, is not included in productive hours because this is done by Western Electric and charged to this account under Western's billing. The staff chose not to use the utility's normal method of calculating workload and productivity because it does not have much meaning for this account. The staff claims work units based on the number of plant items like stations in service has little to do with work performed since most work is generated by trouble reports. As a result, productivity, which is work units per hour, also becomes distorted. Employee-recorded productivity could actually increase when in reality the employees may have become less efficient or vice versa. This is because productivity is more a measure of the number of repair hours spent on telephones in service rather than a measure of how efficient Pacific repairs telephones that are out of service. The staff made its estimate of hours by trending the ratio of the number of hours per trouble report times Pacific's estimated number of trouble reports in 1981. **We find Pacific's position on this issue is reasonable and will increase the staff estimate for Account 605 by $29.9 million.**

**Account 606 contains the cost of repairing buildings and grounds, their fixtures and appurtenances. Pacific's estimate is $1,411,000 over the staff estimate of $55,088,000. Although the staff used a different method to estimate this account than Pacific,**

the major difference is caused by different estimates of construction in 1981. The staff used the April 1980 construction view of 1981 for land and buildings which was lower than the preliminary April view used by Pacific in its NOI. We will adopt the staff's estimate for Account 606.

The staff's estimate of Account 610 is higher than the one made by Pacific in its NOI which was made six months earlier than the staff's. Account 610 represents approximately one-half of the total electricity costs of Pacific. The other electricity costs are charged to a clearing account (707) and then spread to various expense accounts such as maintenance, traffic, commercial and to construction for heating, lighting, etc. on the basis of floor space assigned to each category.

Pacific's estimate for Account 610 for 1981 is $26,043,000 which is $5,668,000 less than the staff estimate of $31,711,000. The staff claims Pacific overestimated its electrical expenses charged to expense accounts other than 610 by $4,400,000. The staff made an electrical energy adjustment for that amount which is shown on Table 4 as a red figure of $4,400,000.

The staff made its estimate by first determining how much electric power the various utilities in California would supply Pacific through June 1980 and the cost of that power. It next determined for each utility the percentage of its power costs directly related to changes in its Energy Cost Adjustment Clause (ECAC) and the percentage related to changes in base rates. The staff believes this is appropriate because these two components of power cost do not increase or decrease by the same percentage, nor do the changes in rates necessarily occur at the same time. The staff then consulted with representatives of the electric utilities and members of the Commission staff who work on electric utility applications. Also the staff reviewed electric utility decisions and pending and proposed electric utility rate increase applications. With this information the staff adjusted each of the electric utilities estimated kilowatt-hour (kWh) costs to Pacific for increases and decreases in ECAC and base rates. The electric utility rate schedules most applicable to the utility were used for determination of increases and decreases in base rate and ECAC.

Pacific claims that actual cost to it through July 1980 would indicate that the staff's estimate should be even higher than it is. Pacific maintains the increase in prices of electrical energy coupled with the knowledge that all the principal electric utilities in California have major rate cases on file for increases makes it clear that the cost for this account should be based at least on the July 1980 per kWh charge of 6.1¢ rather than the staff's 1981 estimate of 5.7¢. Pacific points out that the staff estimated the 1980 over 1979 increase would be 36.8%, while the 1981 over 1980 increase would be only 9.6%. Pacific argues that the charge should be at least at the 6.1¢ level. If this were done, Account 610 for 1981 should be increased by at least 7% based on the July 1980 actuals; this would revise the staff's forecast to $33.9 million compared to its present estimate of $31,711,000.

Pacific's point is well-taken and we will adopt the forecast of $33,900,000 for Account 610 coupled with the staff's electrical energy adjustment of $4,400,000.

As for the other accounts in the maintenance expense group, the estimates of the staff are reasonable and will be adopted.

Depreciation Expense

| | |
|---|---|
| Pacific | $896,221,000 |
| Staff | 852,566,000 |
| Difference | 43,655,000 |

Depreciation and depreciation reserve are derivative accounts; that is, once the investment has been determined, the depreciation and depreciation reserve are automatically determined by the depreciation rates which are agreed to by the Commission and Pacific on an annual basis. In this proceeding the staff's forecast is $38,000,000 less than Pacific's (see Table 6); this results from staff's forecast for plant-in-service being lower than Pacific's for both 1980 and 1981. Pacific takes no exception to the staff estimates for depreciation and depreciation reserve providing the Commission adopts the staff plant-in-service estimates which, with some exceptions, we will do in this proceeding.

TABLE 6

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Depreciation Expense
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Depreciation Expense | $859,923 | $897,927 | $38,004 | $859,900 |
| Allocation to Nevada | (21) | (21) | 0 | - |
| IDC Rate Adjustment | (307) | (307) | 0 | (300) |
| IDC Short-Term CWIP Adj. | 2,459 | 2,459 | 0 | 2,500 |
| Total Deprec. Exp. | 862,054 | 900,058 | 38,004 | 862,100 |
| Remaining Life Adj. to Other Operating Expenses | | | | |
| a. Maintenance Exp. | (845) | (1,317) | (472) | |
| b. Traffic Expense | (16) | (24) | (8) | |
| c. Commercial Exp. | (78) | (122) | (44) | |
| d. Bal. Oth. Exp. | (62) | (97) | (35) | |
| e. Total (a. to d.) | (1,001) | (1,560) | (559) | 1,000 |
| Total Adj. Depreciation Exp. | 861,053 | 898,498 | 37,445 | 861,100 |
| Reversal of Cl. Acc. Amts. (Reassign to proper accts.) | 1,001 | 1,560 | 559 | 1,000 |
| Affiliated Int. Adj. | (9,488) | (3,837) | 5,651 | (9,200) |
| Recast Depreciation Exp. | 852,566 | 896,221 | 43,655 | 852,900 |
| Adjustments: Modernization | | | | 400 |
| | | | | 853,300 |

(Red Figure)

We do wish here, however, to make some comments on the depreciation Pacific is taking on its total plant. As will be discussed later under the section on rate design many of the accounts of Pacific are in a very high percent condition, the percent condition being the relationship of the undepreciated investment to total investment. We believe the overall percent condition of Pacific's reserve account, as can be noted from Table 7 for 1979, the latest information we have on this record, is too high, and in particular for some of the subaccounts it is far out of line. This situation may contribute to some of the problems we will discuss later concerning costing methods of Pacific, as well as Pacific's problems with its cash-flow and financing. If we were to authorize Pacific to depreciate its plant at a faster rate, it would generate not only internal capital for investment purposes, but also lower the rate base, thereby requiring a lower income after taxes to support the rate of return found reasonable by the Commission. We will discuss this matter further under other issues and we will make some recommendations concerning what can be done about the situation.

# TABLE 7

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

SUMMARY OF
ANNUAL DEPRECIATION RATE DETERMINATION
STRAIGHT LINE REMAINING LIFE METHOD

YEAR 1980

| Account Number | Description | Gross Plant Jan. 1, 1979** (a) | Est. Future Net Salvage % (b) | Net Salvage Amount (c)=(a)x(b) | Depr. Reserve Jan. 1, 1979** (d) | Net Balance (e)=(a)-(c)-(d) | Avg. Service Life (Years) (f) | Avg. Net Salvage % (g) | Avg. Age (Years) (h) | Remaining Life (Years) (i) | Annual Amount (j)=(e)÷(i) | % Gross Plant (Rate) (k)=(j)÷(a) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 212 | Buildings | $ 876,096,409 | 9 | $ 78,858,677 | $ 147,829,940 | $ 649,417,792 | 44.0 | 6 | 11.8 | 35.4 | $ 18,345,135 | 2.09 |
| 221 | Central Office Equipment | | | | | | | | | | | |
| -01 | Manual | 48,902,473 | (6) | (2,934,148) | 28,014,801 | 23,821,820 | 10.4 | (6) | 14.5 | 4.4 | 5,414,050 | 11.07 |
| -02 | Panel | - | - | - | 454,288 | - | - | - | - | - | - | - |
| -03 | Step-By-Step | 586,645,499 | (2) | (11,732,910) | 274,860,153 | 323,518,256 | 12.4 | (2) | 15.0 | 6.8 | 67,399,633 | 11.49 |
| -04 | Crossbar | 1,396,363,064 | 1 | 13,963,631 | 371,212,120 | 1,011,187,305 | 17.5 | 0 | 9.5 | 10.9 | 92,769,478 | 6.65 |
| -05 | Circuit Equipment | 1,459,217,726 | (6) | (86,953,064) | 378,887,748 | 1,157,283,042 | 20.0 | (5) | 7.4 | 14.8 | 78,195,500 | 5.30 |
| -06 | Radio | 122,504,958 | (6) | (7,350,297) | 41,015,415 | 88,839,840 | 23.0 | (2) | 8.4 | 14.5 | 6,802,154 | 3.92 |
| -07 | Electronic | 786,931,736 | 3 | 23,607,937 | 58,033,459 | 705,289,850 | 36.0 | 3 | 3.5 | 33.0 | 21,372,420 | 2.72 |
| 231 | Station Apparatus | | | | | | | | | | | |
| -01 | Teletypewriter * | 100,899,656 | (3) | (3,026,990) | 24,871,049 | 79,055,597 | 11.5 | (3) | 5.5 | 8.6 | 9,192,511 | 9.11 |
| -02 | Telephone & Miscellaneous * | 938,154,461 | 6 | 56,289,268 | 242,336,109 | 639,529,084 | 12.7 | 5 | 5.0 | 9.4 | 68,035,603 | 7.25 |
| -03 | Radio * | 18,144,710 | 1 | 181,447 | 9,102,305 | 8,860,958 | 13.9 | 1 | 6.8 | 8.4 | 1,055,876 | 5.81 |
| 234 | Large Private Branch Exchange | 434,265,648 | 0 | - | 56,588,480 | 377,677,168 | 8.5 | 5 | 5.6 | 6.5 | 58,104,180 | 13.33 |
| 241 | Pole Lines | 256,776,694 | (53) | (136,091,648) | 93,335,225 | 299,533,117 | 37.0 | (45) | 15.6 | 26.8 | 12,077,945 | 4.70 |
| 242.1 | Aerial Cable - Exchange | 905,222,960 | (9) | (81,469,165) | 169,533,295 | 817,158,811 | 34.0 | (9) | 10.1 | 28.4 | 28,772,845 | 3.16 |
| | - Toll | 19,476,821 | 47 | 9,154,106 | 7,072,707 | 3,250,008 | 35.0 | 37 | 23.4 | 11.4 | 151,870 | .78 |
| 242.2 | Underground Cable - Exchange | 968,621,020 | 19 | 184,037,994 | 145,607,895 | 638,975,131 | 46.0 | 18 | 9.8 | 38.8 | 16,468,531 | 1.70 |
| | - Toll | 59,971,586 | 43 | 25,787,782 | 14,160,104 | 20,023,700 | 40.0 | 40 | 17.9 | 27.9 | 717,695 | 1.20 |
| 242.3 | Buried Cable - Exchange | 504,123,216 | (7) | (35,288,625) | 72,600,309 | 466,811,532 | 37.0 | (7) | 6.0 | 32.3 | 14,452,352 | 2.87 |
| | - Toll | 81,821,528 | 11 | 9,000,368 | 28,899,013 | 43,922,147 | 46.0 | 12 | 16.5 | 31.4 | 1,335,794 | 1.71 |
| 242.4 | Submarine Cable - Total | 9,819,073 | 9 | 883,717 | 3,881,616 | 5,053,750 | 37.0 | 21 | 13.5 | 23.0 | 219,728 | 2.24 |
| 243 | Aerial Wire - Exchange | 18,745,688 | (40) | (7,498,275) | 5,594,141 | 20,649,822 | 9.9 | (25) | 9.0 | 5.8 | 3,560,315 | 18.99 |
| | - Toll | 4,381,994 | 15 | 657,299 | 1,036,701 | 2,687,994 | 26.0 | 17 | 17.3 | 13.7 | 196,203 | 4.48 |
| 244 | Underground Conduit | 750,835,802 | (6) | (45,050,148) | 93,279,913 | 702,606,037 | 65.0 | (7) | 9.3 | 56.4 | 12,457,555 | 1.66 |
| 261 | Furniture & Office Eqpt. | | | | | | | | | | | |
| | - Excluding Comp. & AMA Sys. | 78,876,534 | 3 | 2,366,296 | 17,557,328 | 58,952,910 | 28.0 | 3 | 10.9 | 22.0 | 2,679,678 | 3.40 |
| | - Computer & AMA Systems | 47,152,226 | 4 | 1,886,089 | 16,868,122 | 28,398,015 | 11.2 | 4 | 5.0 | 7.5 | 3,786,402 | 8.03 |
| 264 | Vehicles & Other Work Eqpt. | 189,745,512 | 13 | 24,666,917 | 72,499,814 | 92,578,781 | 11.9 | 14 | 5.0 | 8.0 | 11,572,348 | 6.10 |
| | SUB-TOTAL - EXCL. STA. CONN. | $10,653,686,474 | .1 | $ 13,936,258 | $2,375,132,047 | $8,265,072,457 | 21.2 | | 8.7 | 15.5 | $533,196,430 | |
| 232 | Station Connections **Jan. 1, 1980 | 1,387,155,398 | (18) | (249,687,972) | 95,371,075 | 1,541,472,295 | 7.6 | (17) | 3.8 | 9.1 | 169,392,560 | 11.45 |
| | Total Depreciable Plant | $12,040,841,872 | (2.0) | $(235,751,714) | $2,470,503,122 | $9,806,544,752 | 26.7 | | 8.2 | 14.0 | $702,588,990 | 5.84 |

( ) Indicates Negative
* Excludes Investment in special subaccounts 231-31, 231-32 & 231-33.

Traffic Expenses

| | |
|---|---|
| Pacific | $417,822,000 |
| Staff | 406,256,000 |
| Difference | 11,566,000 |

Expenses included in the traffic accounts are for three primary functions:

1. Operator handling of calls.
2. Administrative control of the network.
3. Customer instruction in the use of business communications systems.

As can be noted on Table 8, the difference in total traffic expense estimates between Pacific and the staff is $16,860,000 before adjustments and $11,566,000 after adjustments. The main difference between Pacific and the staff is Account 624 for operator wages where the staff made higher estimates of overall efficiencies for the company's operators than did Pacific.

Pacific's witness estimated that the traffic expense for 1981 over 1980 would increase by 11.9%. He testified that labor saving technology kept the workload cost increase to .7% points. However, inflation and hourly wages added 10.8% points, the two factors together compounding to an increase of 11.9%.

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

TABLE 8

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Traffic Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 621 | Genl. Traffic Supervision | $ 47,179 | $ 48,342 | $ 1,163 | $ 47,200 |
| 622 | Serv. Inspec. & Cust. Instr. | 9,219 | 9,219 | 0 | 9,200 |
| 624 | Operators Wages | 283,007 | 296,848 | 13,841 | 283,300 |
| 626 | Rest and Lunchrooms | 926 | 980 | 54 | 900 |
| 627 | Operators Employment & Train. | 13,974 | 14,536 | 562 | 14,000 |
| 629 | C.O. Stationery and Printing | 9,593 | 9,753 | 160 | 9,600 |
| 630 | C.O. House Services | 3,245 | 3,380 | 135 | 3,200 |
| 631 | Misc. Traffic Ofc. Exps. | 34,831 | 35,563 | 732 | 34,800 |
| 632 | Public Telephone Exps. | 200 | 413 | 213 | 200 |
| 635 | Joint Traffic Expenses-CR. | (453) | (453) | 0 | (500) |
| | Subtotal Before Adjs. | 401,721 | 418,581 | 16,860 | 401,900 |
| | Decision 91495 Adj. | (735) | (735) | 0 | (700) |
| | Total Traffic Exps. | 400,986 | 417,846 | 16,860 | 401,200 |
| | Deprec. S.L.- R.L. Adj. | (16) | (24) | (8) | - |
| | Adjusted Traffic Expenses | 400,970 | 417,822 | 16,852 | 401,200 |
| | Tran. to Long Line | (2,406) | 0 | 2,406 | (2,400) |
| | Wage Contract Adj. | 7,692 | 0 | (7,692) | 7,700 |
| | Recast Traffic Exps. | 406,256 | 417,822 | 11,566 | 406,500 |

(Red Figure)

The staff's analysis was based on total measured production salaries which are spread over three accounts, 621, 624, and 627. Over 90% of the salaries are allocated to Account 624 where they contribute over 80% of the total account expense. Total measured production salaries are those portions of traffic salaries associated with operator supervision, force administration, clerical, and training. The difference in Pacific's and staff's forecast for Account 624 is $13.8 million; this is the major difference between the staff and Pacific for traffic expense estimates. Pacific claims the primary reason for the staff being so much less than Pacific is because the assumed overall efficiency the staff chose is grossly overstated for the positions involved and the salaries in the accounts. Pacific cites, as an example, that a change from 76.5 to 74.5 for only one of the efficiency factors results in about a $3.2 million additional salary requirement. Pacific claims that as an alternative to either of the staff's or Pacific's estimate, Exhibit 257 may be used to make an independent forecast of the traffic expenses based on appropriate overall efficiency levels. Pacific claims that in addition to any changes in an account,such as 624, changes in Accounts 626, 629, 630, and 631 must be revised proportionately depending on the change in total measured production salaries.

We will adopt the staff estimates with one exception. The staff witness on traffic expenses made an adjustment for efficiency salaries in 1981 for the Stockton Directory Assistance Office. He claimed that because of the postponement of the installation of certain systems in Stockton a $305,000 efficiency saving was not realized. However, the staff witness acknowledged on cross-examination that he had made no inquiry on how a conversion would fit in with the priorities of Pacific's total capital program. Pacific claims it postponed the Stockton conversion because of a technical problem with the improved system. Therefore, Pacific claims the economic desirability of deferring the Stockton improvement made good sense.

We will adopt the estimate of the staff for traffic expenses with the exception of the $305,000 adjustment for the Stockton Directory Assistance Office. The adopted total is $406,500,000.

Commercial Expenses

| | |
|---|---|
| Pacific | $730,766,000 |
| Staff | 706,121,000 |
| Difference | 24,645,000 |

Commercial expenses support customer account servicing, business service centers, residence service centers, marketing activities, directory operations, advertising, and staff support. The major differences (see Table 9) between Pacific and staff result from staff adjustments based on attainment of service objectives by Pacific and what Pacific terms "1980 underruns". For purposes of this proceeding, Pacific does not contest the estimates made by the staff for Accounts 644, 648, 649, and 650.

For Account 640 Pacific accepts all of the staff adjustments except for deletion of three manager positions, a total reduction of $153,000. We will discuss the staff's recommendation for that adjustment under Account 645.

TABLE 9

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Commercial Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 640 | Genl. Commercial Admin. | $107,519 | $116,106 | $ 8,587 | $107,700 |
| 642 | Advertising | 24,000 | 27,873 | 3,873 | 24,000 |
| 643 | Sales Expense | 82,524 | 86,641 | 4,117 | 82,500 |
| 644 | Connecting Co. Relations | 1,059 | 1,136 | 77 | 1,100 |
| 645 | Loc. Commercial Opers. | 332,367 | 342,939 | 10,572 | 335,400 |
| 648 | Public Telephone Comms. | 22,055 | 22,751 | 696 | 22,100 |
| 649 | Directory Expenses | 136,328 | 136,345 | 17 | 136,300 |
| 650 | Other Commercial Exps. | 50 | 50 | 0 | 100 |
| | Subtotal Before Adjs. | 705,902 | 733,841 | 27,939 | 709,200 |
| | Prior Advertising Disallowances | (2,876) | (2,846) | 30 | (2,900) |
| | Open Line Advertising Adj. | (500) | 0 | 500 | (1,000) |
| | Multistate Marketing Adj. | (5,718) | 0 | 5,718 | (5,700) |
| | Subtotal Adjustments | (9,094) | (2,846) | 6,248 | (9,600) |
| | Total Commercial Expenses | 696,808 | 730,995 | 34,187 | 699,600 |
| | Dues and Donations Adj. | (107) | (107) | 0 | (100) |
| | Deprec. S.L.-R.L. Adj. | (78) | (122) | (44) | (100) |
| | Adjusted Commercial Exps. | 696,623 | 730,766 | 34,143 | 699,400 |
| | Wage Contract Adj. | 9,498 | 0 | (9,498) | 9,500 |
| | Recast Commercial Exps. | 706,121 | 730,766 | 24,645 | 708,900 |

(Red Figure)

For Account 642 advertising, the difference between Pacific and the staff is $3,873,000. Pacific accepts all of the staff adjustments proposed for Account 642 with the exception of its $500,000 adjustment for Openline. Openline is a 7" x 7", 4-page bill insert which Pacific began distributing to all residential customers in October 1979. Five issues had been distributed through July 1980 and Pacific indicated that it plans to publish a total of 10 during 1980 and 12 during 1981. Openline generally contains short articles about Pacific. Staff believes that only a portion of the Openline articles to the date of their review were of a type for which expenses could properly be allowed for ratemaking. According to the staff Pacific maintained that the balance of the articles are chosen to promote readership and that the publication has been successful in that regard. Staff, however, notes that the Commission in the past has disallowed expenses for informative advertising which was not of significant benefit to customers. Staff claims that much of Openline's content is this type or institutional advertising which the Commission has consistently disallowed. Staff believes too many of the articles are designed to reflect credit upon Pacific or the Bell system. Because a portion of Openline articles have been useful and none have been patently objectionable, according to the staff, the staff would not recommend the Commission completely disallow Openline costs and proposes that 50% of the costs be allowed for ratemaking.

Pacific claims the concept of Openline is generally approved by the staff and that the staff agrees that wide readership is essential in carrying out the objectives of the Openline concept, that is, to provide information of benefit to Pacific's customers. Staff stated that the Commission in D.88232 (1977) 83 CPUC 149, 190, said:

> "We have previously made it clear that institutional advertising (which tends to build the image of the company) will not be charged to the ratepayer. Several recent cases have explained our current policy on advertising. Staff witness Dade's testimony...contains a fair summary of what these recent cases classify as allowable advertising (assuming a reasonable limit): (1) advertising that provides a net increase in revenue or a net decrease in expenses; (2) advertising which instructs customers how to obtain or use their service more efficiently or economically, or advises them of legal or rate matters as required by this Commission, or promotes safety; and (3) advertising for recruiting employees or protecting utility property."

Staff maintains it used those three criteria in judging whether Openline articles they reviewed would be allowed for ratemaking. The staff witness' conclusion was that Openline generally benefits the stockholders as much as the ratepayers and that they should share equally in the cost. Therefore, the staff is recommending a 50% disallowance.

We believe the value of Openline to the ratepayers is minimal, particularly in light of the many other forms of communication used by Pacific to provide necessary information to the ratepayers. While the expense of Openline might not be objectionable in less turbulent economic circumstances, today every effort must be made to protect the ratepayer from incurring expenses which could be avoided. Pacific has not demonstrated that Openline contributes measureably to improve communications with customers or to improve service. Consequently, we disallow the entire $1,000,000 expenditure for this item and invite the shareholders to assume this responsibility if they choose.

While we adopt the staff recommended allowance of $24 million for advertising, $3.9 million below Pacific's estimate, we are not convinced that the record was developed as fully as desirable on this issue. As Pacific moves through the coming transition into partial deregulation, great care must be taken to assure that ratepayer funds are not used to promote deregulated activities. In subsequent proceedings to consider allocation of costs of deregulated activities, the staff and others are urged to more fully explore this question.

We are also concerned about the sheer size of the advertising budget. Consumers frequently question the need for a regulated monopoly such as Pacific to advertise. While there is clearly a value to certain kinds of advertising designed to increase volume and thus reduce per unit rates, it does not appear that the advertising program was carefully analyzed from the perspective of value to the ratepayers. Both Pacific and the staff should develop a more thorough record on this question in Pacific's next general rate case.

For Account 643, Sales Expense, the difference between staff and Pacific is $4.1 million. Pacific accepts three adjustments the staff made: (1) in the residence portion amounting to $11,000, (2) for the advanced communications system postponement amounting to $1.2 million, and (3) for the multistate marketing overestimation amounting to $616,000. Pacific strongly disagrees with two other adjustments made by the staff: (1) an adjustment of $1.497 million for overestimation of 1980 base amounts and (2) an adjustment of $759,000 deleting what the staff termed an "unsupported lump sum to provide more normal level of expenses" included by Pacific.

The adjustment of $1,497,000 for overestimation of the 1980 base amount is contested by Pacific because it believes there is critical need for the increased sales expenses to meet the increasing pressures of competition in its customers' servicing needs. Pacific's witness Brown said that the company's forecasts are based on the resources needed to do the job in 1981 and that the staff's method, which is based on underruns in some of the commercial accounts for part of 1980, fails to consider the fact that during any year partial-year underruns may be compensated for by overruns in the latter part of the year. However, as we pointed out earlier in our general discussion on expenses the staff has acknowledged that moving into 1980 Pacific abandoned its constrained budget for a higher level of expenses based on its December 1979 commitment budget and the staff has taken these effects into account. We will accept the staff's estimate.

Concerning the lump sum $759,000, which Pacific claims is needed to provide a more normal level of expense, we agree with the staff that a nondelineated lump sum of that nature should not be allowed. If an amount that size can be determined, then its purpose should be known to Pacific. We will accept the staff's estimate of $82,524,000 for Account 643 for 1981.

For Account 645, Local Commercial Operations, the difference between staff and Pacific estimates is $10,600,000. Again, Pacific claims that a large portion of the difference, approximately $3.3 million, is the staff's conclusion that there has been an over-estimation of the 1980 base amounts. Pacific uses the same argument here as it did for Account 643 and again we will not accept it.

A second major difference between Pacific and the staff is for expenses associated with residence service center and business service center improvements. In support of its estimate Pacific cites 1979 actual and 1980 and 1981 target levels for efficiency measurements of its business and residence service center offices. Staff claims that Pacific's efficiency measurements have soared in 1980 and are currently far above the utility's stated target for 1981. Additionally, staff does not believe a special expense allowance to improve residence service centers in 1981 is warranted and it does not believe Pacific would apply any of the funds requested for that purpose. Staff, therefore, excluded $3,198,000 it has identified in Pacific's work papers associated with the improved residence service center service.

Staff claims that Pacific has also included in its exhibits and work papers additional employees and expenses it believes are necessary to improve the service levels in its business service centers. Staff claims the same arguments it made for the residence service center disallowance apply to the business service centers as well. It does not believe a special expense allowance to improve business service centers in 1981 is warranted, nor does it believe the utility would apply any of the funds requested for that purpose. Therefore, staff has excluded $3,227,000 it identified in the company's work papers for Accounts 640 and 645 as applying to improve business service center service. The portion in Account 640 is for the previously mentioned three manager positions, totaling $153,000.

Pacific claims the staff looked at only one of the three submitted service objectives for business service centers which had reached the 1981 target level during 1980 and deleted the entire service improvement expense on that basis. The staff acknowledged that Pacific was among the poorest companies in the Bell System in terms of the satisfaction of business service customers. In addition, the staff agreed that 1981 objectives set by Pacific are reasonable. We will accept the staff estimate adjusted for the $3,227,000. Therefore, for Account 640 we will accept the staff's estimate of $107,519,000 adjusted by $153,000, for a total of $107,672,000, rounded to $107,700,000. For Account 645 we will accept the staff estimate of $332,367,000 adjusted by $3,074,000 ($3,227,000 - $153,000) for a total of $335,441,000, rounded to $335,400,000.

The final major expense adjustment recommended by the staff involves multistate marketing (MSM). The staff recommends $5,718,000 be excluded from 1981 estimated commercial expenses. MSM is a cost-sharing arrangement within the Bell System by which AT&T's Long Lines Department (Long Lines) assumes the responsibility for marketing intrastate and interstate products and services for designated large multistate customers. The purpose of this is (1) to permit more responsive service by providing a single point of contact for customers needing services from more than one Bell company thus eliminating coordination problems among jurisdictions and (2) to promote more effective marketing to these customers than was previously possible. MSM cost recovery is accomplished by prorating the expenses of the activity to OTCs based on total interstate and intrastate revenue in each jurisdiction. The federal government is the largest multistate customer. Federal government MSM costs have been estimated separately by the staff and Pacific and are not at issue in this disallowance. The disallowance involves Pacific's taking over marketing for the remaining multistate customers with Long Lines billing. This is referred to as Pacific MSM. The staff bases its proposed disallowance on three points:

a. Pacific has been unable to demonstrate the cost-effectiveness of Long Lines MSM.

b. Long Lines MSM is not really a new program warranting such a large increase in expenditures. It is a continuation of the existing Long Lines national account management program.

c. In Pacific MSM, Pacific has assumed full account management responsibility for Long Lines billed accounts previously managed in part by Long Lines but Pacific has no reciprocal mechanism for recovering its costs.

The staff was unable to ascertain the reasonableness of MSM expenses for Pacific. Staff found that there were no Long Lines MSM expenses recorded by Pacific prior to 1980. In 1980 the staff estimates that Long Lines will bill Pacific $8,720,000 and in 1981, $11,436,000. Since Long Lines in 1980 initiated billing to Pacific for marketing work done on Pacific's behalf, it would seem appropriate to the staff that Pacific reciprocate for work it performs on Long Lines' behalf because Pacific is assuming full account management responsibility for approximately 300 - 500 accounts; these are firms headquartered in California, but with regional or national communications facilities. In effect, Pacific account executives will now be marketing interstate services which will be billed by Long Lines. Therefore, staff recommends that the Commission disallow one-half of the estimated 1981 $11,436,000 AT&T's Long Lines' billings to Pacific. That would amount to an adjustment of $5,718,000. We will adopt that recommendation.

No other estimates for commercial expenses, Table 9, are in dispute among Pacific, the staff, or other parties.

There is another matter under commercial expenses which received considerable attention in this proceeding. In D.91495 dated April 2, 1980 we authorized an interim increase for Pacific of $227,000,000 based on a 1980 test year. Included was a staff recommendation of $69,400,000 to cover estimated intrastate operating expenses6/ for increased marketing efforts to meet competition for services which are competitive. It was expected during this proceeding that Pacific would offer testimony on the use of the revenues and the results it was producing. However, witness Brown under questioning by the ALJ indicated Pacific made no special application of the $69.4 million,7/ instead, it had been absorbed into the stream of expenses incurred by the company on a current basis. Although the $69.4 million may not have been used entirely for the purpose intended by D.91495, the actual 1980 results of operations on Table 26 show that Pacific did not exceed the rate of return granted. Therefore, no purpose would be served if we were to rescind the increase and order a refund. As for the 1981 estimate staff witness McVickar treated 1981 as a normal test year in reviewing Pacific's estimates. He found no unproductive marketing effort which would require special treatment of the marketing expenses of Pacific as was required for the staff's 1980 estimates.

There is only one other matter to dispose of under commercial expenses. The staff singled out expenses for International Direct Distance Dialing (IDDD) advertising for special treatment in the

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6/ Although this discussion is under commercial expenses, D.91495 indicates that the $69.4 million is applicable to: commercial expense - $28.2 million; maintenance expense - $32.5 million; and associated salary overheads - $8.7 million.

7/ Pacific did offer Item 28 in an attempt to explain that although it was the staff's intention that the $69.4 million was to be used for marketing related expenses in competitive areas, Pacific did not agree and used the funds to cover costs of increased demands for service, inflation, and correction of service problems.

separation of interstate and intrastate expenses. The staff identified $559,000 for estimated 1981 IDDD advertising expenses and allocated this total entirely to interstate operations prior to making the separation to intrastate. The staff claims the amount deleted is for the purpose of IDDD promotion, an ethnic holiday promotion, an IDDD bilingual telephone guide, and business direct mail IDDD stimulation. According to the staff, the stated purpose of each of these campaigns by Pacific is to increase international revenues which are treated as interstate revenues. Thus, the California ratepayer will not receive any direct revenue benefit from the expenses. Each of these campaigns was inaugurated in 1980.

In making their recommendation the staff relies on what it believes to be similar treatment by the Commission of advertising expenses in D.85287 of Pacific (79 CPUC 240, 247) and D.88232 of Pacific (83 CPUC 149, 195). In those two decisions the Commission adopted the concept that a direct distance dialing campaign cannot be conducted which only stimulates intrastate toll calls without having at least a similar effect on out-of-state call volumes which benefits AT&T's Long Lines. The Commission concluded that such a campaign would benefit Pacific 50% and AT&T's Long Lines by 50%. Therefore, of the expenses involved, half would be assigned to Pacific's total operations and of that half, the normal allocation of advertising expense to intrastate would be made. For example, if the intrastate allocation from Pacific's total operations were 80% and the expense involved on a total basis is $100, $50 would be allocated to Pacific's total operation; of that, 80% or $40 would be allocated to California intrastate. In this case, the staff sees no benefit to California ratepayers. We agree with the staff that it is a campaign to increase international revenues and therefore 100% should be allocated to AT&T's Long Lines; this, of course, would accomplish what the staff recommends, that nothing be allocated to Pacific's intrastate service. We note Pacific's argument that under the separations manual published by NARUC, Pacific may not recover part of the expenses because the total expenses would be partially allocated to Pacific and partially to AT&T's Long Lines. On the other hand, if it cannot be shown that the revenues from the campaign are treated in a like manner, then the expenses must be disallowed. It would appear from this record that all of the extra revenue generated is allocated to AT&T's Long Lines and none of it is allocated to Pacific.

General Office Salaries
And Expenses

| | |
|---|---|
| Pacific | $371,513,000 |
| Staff | 355,621,000 |
| Difference | 15,892,000 |

The major difference here is for Account 662, Accounting Department Expenses; the staff estimate differs from Pacific by $13,789,000. The staff's adjustment is based on a review of expenses through July 1980. Again, Pacific claims this resulted from the staff's taking an underrun and annualizing it. The record shows that this annualized figure was $8.2 million and the staff rounded this to $10 million prior to increasing it to $13.7 million for 1981 on a trending basis. Pacific claims the $1.8 million needed to round the $8.2 million to $10 million is inappropriate and that any 1981 adjustments should start with the $8.2 million. Consistent application of Pacific's 1981 percent increase of 12.7% reduces the staff's accounting department adjustment to $9.24 million. Account 662 therefore as estimated by the staff will be adopted but increased by the difference between $13.7 million and $9.24 million, or $4.46 million.

Account 662 also contains costs for postage. Postage rates were increased in March 1981 and neither Pacific's nor the staff's estimates reflect the increase. Staff Exhibit 246, page 15-8, shows postage costs equal to about $16.5 million per year. We will adjust Account 662 by three-fifteenths (postage rates for first class went from 15 cents to 18 cents) or a total of $3.3 million.

Other general office salary and expense estimates of the staff will be adopted. No further discussion is required at this point, except to note that antitrust activities adjustments are discussed elsewhere in this decision.

TABLE 10

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted General Office Salaries and Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 661 | Executive Department | $ 1,872 | $ 1,902 | $ 30 | $ 1,900 |
| 662 | Accounting Department | 173,215 | 187,004 | 13,789 | 181,000 |
| 663 | Treasury Department | 9,226 | 9,226 | 0 | 9,200 |
| 664 | Law Department | 8,447 | 8,447 | 0 | 8,400 |
| 665 | Other Genl. Ofc. | 165,857 | 165,857 | 0 | 165,900 |
| | Subtotal Before Adjs. | 358,617 | 372,436 | 13,819 | 366,400 |
| | Citizenship Activities | (124) | (124) | 0 | |
| | Legislative Advocacy | (521) | (521) | 0 | |
| | Shareholder Visits | (382) | (382) | 0 | |
| | Antitrust Activities | (378) | 0 | 378 | |
| | Subtotal Adjs. | (1,405) | (1,027) | 378 | (1,400) |
| | Total Genl. Ofc. Exps. | 357,212 | 371,409 | 14,197 | 365,000 |
| | Reassign Adjs. to Proper Accts. | | | | |
| | a. Dues & Donations | (117) | (117) | 0 | |
| | Reverse Overhead Loading for: | | | | |
| | b. Citizenship Activities ) | | 27 | 0 | |
| | c. Legislative Advocacy ) | 221 | 107 | 0 | |
| | d. Shareholder Visits ) | | 87 | 0 | |
| | e. Subtotal Adjs. | 104 | 104 | 0 | 100 |
| | Adjusted Genl. Ofc. Exps. | 357,316 | 371,513 | 14,197 | 365,100 |
| | Wage Contract Adj. | (1,695) | 0 | 1,695 | (1,700) |
| | Recast Genl. Ofc. Exps. | 355,621 | 371,513 | 15,892 | 363,400 |

(Red Figure)

orig.
10

Other Operating Expenses

| | |
|---|---|
| Pacific | $811,883,000 |
| Staff | 675,032,000 |
| Difference | 136,851,000 |

The staff made major adjustments to Pacific's expenses for relief and pensions. The total difference in the estimates is $70.5 million (Table 11). A large contributor to the difference is the staff's use of lower force levels associated with the expense levels the staff made for the main operating accounts. The staff witness stated that if the adopted force levels are different from those on which he based his adjustments, there would be a per-employee expense change.

# TABLE 11

## THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Other Operating Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 668 | Insurance | $ 960 | $ 960 | $ 0 | $ 1,000 |
| 669 | Accident & Damage | 2,405 | 2,405 | 0 | 2,400 |
| 671 | Operating Rents | 51,889 | 54,412 | 2,523 | 51,900 |
| 672 | Relief & Pensions | 559,669 | 630,202 | 70,533 | 630,200 |
| 674 | Genl. Service & Licenses | 55,515 | 88,355 | 32,840 | 57,500 |
| 675 | Other Expenses | 62,435 | 64,093 | 1,658 | 62,400 |
| 677 | Expense Charged to Const. | (32,629) | (34,433) | (1,804) | (32,600) |
| | Subtotal Before Adjs. | 700,244 | 805,994 | 105,750 | 772,800 |
| | Exclusion of Dues & Donations | (738) | (647) | 91 | (700) |
| | Relief and Pensions | 419 | 419 | 0 | 400 |
| | Decision 91495 (Incl. Advice Ltr. 13641) | 7,463 | 7,463 | 0 | 7,500 |
| | Pioneer Activities | (195) | 0 | 195 | - |
| | Subtotal Adjustments | 6,949 | 7,235 | 286 | 7,200 |
| | Total Other Oper. Expenses | 707,193 | 813,229 | 106,036 | 780,000 |
| | Reformat - Reassign adjs. to proper accts. | | | | |
| | a. Dues & Donations (Commercial Exp.) | 107 | 107 | 0 | |
| | b. Dues & Donations (G.O. Sal. Exp.) | 117 | 117 | 0 | |
| | c. Depr. S.L.-R.L. (Bal. Oth.) | (62) | (97) | (35) | |
| | d. Pen. & Payroll (Bal. Oth. Overhead Loading) | (221) | (215) | | |
| | e. Dues & Donations (Gen. Ofc. | 6 | | 0 | |
| | Overhead Loading) | 38 | 38 | | |
| | f. Subtotal | (15) | (50) | (35) | - |
| | Traffic Exp. Adj. | 44 | 0 | 44 | - |
| | Tran. to Long Line | (3,781) | 0 | 3,781 | (3,800) |
| | Wage Contract Adj. | (27,113) | 0 | 27,113 | (27,100) |
| | Rescinded-Advice Ltr. 13641 | (1,296) | (1,296) | 0 | (1,300) |
| | Recast Other Oper. Exps. | 675,032 | 811,883 | 136,851 | 747,800 |

(Red Figure)

A major difference, $27.6 million, between the staff and Pacific is in the area of pensions and death benefits. The staff's estimates are lower because it used a 16.9% accrual rate compared to Pacific's 17.24% rate and also because of lower labor cost estimates. The 16.9% rate is a revised rate which was provided to Pacific by AT&T July 31, 1980; the staff assumed this revised rate will also be valid for 1981. Another major difference is $5.2 million for group life insurance. Pacific calculates its life insurance costs the same way it does for pension costs. That is, estimated payroll is multiplied by a rate, .79%, to obtain estimated costs. The rate was supplied to Pacific by AT&T without any information on how it was derived. In the past, Pacific has done its own insurance cost calculations, but this has now been assumed by AT&T. The staff believes there is little reason to accept Pacific's approach especially when its estimated costs for 1981 are $160 per employee compared to life insurance costs of other California utilities ranging from $75 to $113 per employee. Therefore, the staff uses an alternate approach which assumes the fraction representing the recorded relationship in 1979 between life insurance costs and total payroll will remain constant. This fraction when multiplied by the company's gross payroll estimates yielded the staff's estimates. Another large difference, $12.8 million, is in the area of basic medical expense. Primarily the staff's estimate is lower because of different participation ratio assumptions, such as the number of single persons versus the number of employees with two or more dependents. Another factor in the difference is the staff assumption that the premium rates of Blue Cross, which covers most of Pacific's employees, will go up 15% compared to Pacific's 20 to 25% estimate. Staff rationalizes using a lower rate based on the latest agreement between the State of California and Blue Cross which is effective August 1, 1980 through

July 31, 1981. Adjusted for plan changes, costs for the State's contract increased by approximately 13.8%. Also, in May 1980 its forecast of premium increases to about 16½%. A final major difference for Account 672 is for dental plan expenses. Staff is $6.8 million lower than Pacific. The staff estimate for 1981 is based on its estimate that the premium rates will go up by 25% over 1980 compared to Pacific's assumption that they will rise by about 55%. Pacific's consultant claimed that the average premium rate will increase by 13.2% due to higher than anticipated major dental work and that the rest of the company's premium increase will be attributable to materials increases, inflation, and dentists' overhead. The staff concedes that the 13% premium increase seems reasonable but does not believe that general inflation will result in an additional 42%. The staff noted that the July 1980 Consumer Price Index for Medical Services increased by 11.8% over the previous year. It concluded that a 25% increase in total dental expenses (13.2 + 11.8%) was a realistic rate for estimating purposes. Finally, there is a difference of $6.9 million for overlays which results from the staff's capitalizing a greater percentage of costs than does Pacific. The staff uses the experience in 1978 and 1979 to calculate pensions and benefit costs charged to construction and expense. Pacific's work papers indicate an average of the last few years was used to estimate engineering costs capitalized, and seven months in 1979 were used to estimate plant costs capitalized. Overlays represent differences in wage and wage-related costs between the company's operational and corporate views. Pacific's approach in developing overlays is not entirely consistent with its method for estimating pensions and benefits costs; therefore, the staff made an estimate of overlays in order to present figures comparable with Pacific's. The staff estimates are in the proportion that total staff-estimated pensions and benefits costs are to total company-estimated pensions and benefits costs.

Overall for Account 672, we believe **Pacific's estimates are more realistic than the staff's and will adopt them for this decision.**

For Account 674, General Service and License Expense, the staff estimate is $32.8 million lower than Pacific's. This difference and the $57.6 million we will adopt for Account 674 is discussed in the section following on license contract expenses.

Similarly for Account 675, Other Expenses, we will adopt the staff estimate of $62,400,000 which is $1.7 million lower than Pacific's. Comments on that item are contained in the section following on Bell Labs Business Information Systems (BIS).

Only one other item requires discussion under Other Operating Expenses and that is the staff-recommended adjustment of $195,000 for Pioneer activities. Pacific claims that Pioneer activities, which is a program to support its employees who are active in community affairs, have the result of improving employee morale and work attitudes resulting in better job performance. The staff witness who recommended the adjustment agreed that if such activities improved job performance, it would be of benefit to the ratepayers. We will not accept the staff adjustment.

All other staff estimates for other operating expenses not discussed above are reasonable and will be adopted.

Taxes Other Than Income

For operating taxes and deferred tax reserve the forecast made by Pacific and the staff is not in dispute. The differences in estimates (Table 12) are primarily due to the differences in the expense and rate base estimates used as bases for the tax calculation. Any changes which are made in the underlying expenses and revenues are reflected in the tax calculations made. This adjustment is $700,000 and is made to the staff total to be consistent with expenses and rate base adopted.

California Corporation
Franchise Tax

Pacific and staff disagree on the method to be used for forecasting California corporation franchise taxes. While the final determination of the tax depends on adopted estimates for revenues and expenses, Pacific claims the method used by the staff results in a significant underestimation of the tax. Pacific's estimate for franchise tax liability is based on the method used to compute the tax by the Franchise Tax Board (Board). The Board assesses the actual tax based on the Bell System consolidated taxable income as allocated to California based on a three-factor formula. In contrast, Pacific claims that the staff estimates tax by using an average 10-year effective rate unrelated to the actual way the tax is calculated.

TABLE 12

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Taxes Other Than Income
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| | Operating Taxes | | | | |
| 307.1 | Ad Valorem Taxes | $124,486 | $130,895 | $ 6,409 | |
| 307.2 | State Gross Receipts | 892 | 892 | 0 | |
| 307.4 | Other State & Local Taxes | 5,105 | 5,105 | 0 | |
| | Subtotal | 130,483 | 136,892 | 6,409 | |
| | Payroll Taxes | | | | |
| 307.5 | Calif. Unemployment Insur. | 11,300 | 11,858 | 558 | |
| 307.6 | Fed. Unemployment Insur. | 3,955 | 4,151 | 196 | |
| 307.7 | Fed. Insur. Contribution Act | 116,922 | 122,916 | 5,994 | |
| | Subtotal | 132,177 | 138,925 | 6,748 | |
| | Subtotal Before Adjs. | 262,660 | 275,817 | 13,157 | |
| | IDC and Taxes on Land | 6 | 6 | 0 | |
| | Total Taxes Oth. than Income | 262,666 | 275,823 | 13,157 | |
| | Pension & Payroll Taxes Adj. | | | | |
| | Payroll | (43) | (43) | 0 | |
| | Other | (1) | (1) | 0 | |
| | Adjusted Total Taxes Other Than Income | 262,622 | 275,779 | 13,157 | |
| | Tran. to Long Line | (1,057) | 0 | 1,057 | |
| | Wage Contract Adj. | 1,216 | 0 | (1,216) | |
| | Traffic Exp. Adj. | 12 | 0 | (12) | |
| | Recast Total Taxes Other Than Income | 262,793 | 275,779 | 12,986 | $262,800 |
| | Adjust for Adopted Expenses | | | | 700 |
| | Total Adopted Expenses | | | | 263,500 |

(Red Figure)

Table 13, which is based on information contained in Exhibit 331, shows for the last 10 years the taxable income, tax at the statutory rate, and the actual tax paid. Also shown is the relationship of the statutory rate tax compared to the actual tax paid. Because of the relationship of the Bell System to California the actual tax paid exceeds the tax at the statutory rate which is currently 9.6%. The staff in conformance with previous Commission decisions uses an average of the last 10 years to determine the rate to be used. In this particular case it is 12.5% which is 1.307 x 9.6%, the 1.307 being the relationship of the last 10 years actual tax to the statutory tax. Pacific recommends the latest three years be used to calculate the multiplier to be applied to the statutory rate of 9.6%. In this case the result would be an effective tax rate of 15% instead of the staff's 12.5%. An examination of the three years used by Pacific 1977, 1978, and 1979 shows 1979 to be significantly out of line with the previous two years and, in fact, the previous nine years which were used by the staff in addition to 1979. We will adopt **the latest five years as more nearly reflecting current conditions.**

TABLE 13

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
Computation of Effective Tax Rate for California Corporation
Franchise Tax
Test Year 1981
(Dollars in Thousands)

| Year | Separate Return Taxable Inc. | Tax @ Statutory Rate | Actual Tax Paid | $\frac{(c)}{(b)}$ |
|---|---|---|---|---|
| | (a) | (b) | (c) | (d) |
| 1970 | $ 333,273 | $ 23,329 | $ 25,534 | 1.095 |
| 1971 | 283,312 | 19,832 | 20,551 | 1.036 |
| 1972 | 178,066 | | | |
| 1973 | 287,298 | 23,846 | 28,578 | 1.198 |
| 1974 | 296,374 | 26,674 | 30,630 | 1.148 |
| 1975 | 295,755 | 26,618 | 29,025 | 1.090 |
| 1976 | 324,826 | 29,234 | 37,608 | 1.286 |
| 1977 | 314,950 | 28,345 | 39,945 | 1.409 |
| 1978 | 439,051 | 39,515 | 52,028 | 1.317 |
| 1979 | 262,243 | 23,602 | 51,002 | 2.161 |
| Total | 3,015,148 | 240,995 | 314,901 | 1.307 |
| 5 yrs., 75-79 | | 147,314 | 209,608 | 1.423 |

1.307 x 9.6 = 12.5%
1.423 x 9.6 = 13.7%

For determination of the additional franchise tax liability which results when increased rates are granted, the staff claims that the 12.5% is not appropriate. Pacific's tax liability for franchise tax is not solely dependent on its California operations. Because it is part of the Bell System, the Board has taken the position that its tax liability should be determined with reference to a "combined report" of the Bell 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 Bell System operations in California to the same three factors for the Bell System. Because when increased rates are granted only the revenue factor changes, the impact of any increase affects only that factor, not all three. Further, only Pacific's California intrastate revenues are affected by rate increases granted by this Commission. In consideration of these factors the staff has determined that the proper incremental tax rate for any increase in rates granted by the Commission is 1.34%.

Net-To-Gross Multiplier

This is also the rate used by the staff for development of its net-to-gross multiplier which is 1.896. That factor is developed as follows:

| | |
|---|---|
| Gross Operating Revenues | 100.00 |
| Uncollectibles at 1.00 (intrastate operations only) | 1.00 |
| | 99.00 |
| State Corp. Fran. Tax @1.34% | 1.33 |
| | 97.67 |
| Fed. Income Tax @ 46% | 44.93 |
| Net Revenue | 52.74 |

Gross Multiplier = 100.00 ÷ 52.74 = 1.896

Federal Income Tax

Consistent with D.91337 dated February 13, 1980 the staff developed its estimates for federal income tax based on a "full normalization" basis subject to refund upon completion of the litigation with Internal Revenue Service (IRS) concerning the use of the AAA and AA methods. Additional discussion of accelerated depreciation is contained under the section on Other Issues which follows.

License Contract Expenses

AT&T, through what are known as license contract agreements, provides the OTCs advice and assistance in engineering, plant, traffic, commercial, accounting, legal, and other telephone business matters. AT&T also furnishes financial advice and assistance and agrees to pursue fundamental research, investigation, and experimentation in the development of telecommunications and makes the benefits of this work available for use by the OTCs. The first of these agreements existed prior to the turn of the century. At that time, they primarily covered the rental of telephone equipment by AT&T to the OTCs. The present general form of the contracts was established in 1918. Current contracts provide that OTCs will pay a fee of no more than 2.5% of their operating revenues in return for the services AT&T provides. The estimated amount billable to Pacific for 1981 exceeds $134 million. From 1948 until 1974 the OTCs were required to pay only 1% of their revenues to AT&T. In 1974, AT&T unilaterally changed the method of billing by notifying the OTCs that they would be billed their allocated share of AT&T's costs plus a return on the associated investment but not to exceed 2.5% of the OTCs gross revenues.

The Commission first examined the reasonableness of the fees in 1947 in A.28211, a general rate proceeding of Pacific. In D.41416 issued April 6, 1948 (48 CPUC 1) the Commission found that the "so called license contract or agreement is, in fact and in law, not a contract or agreement but is in essence a directive or a requirement imposed upon Applicant by the American Company." In that proceeding, the Commission disregarded the agreement in determining a reasonable amount for the services AT&T provided Pacific. In subsequent general rate proceedings of Pacific, the Commission has adopted the same fundamental approach. Any issues that arose in later proceedings were limited to the determination of the proper, just, and reasonable allocation of the costs. In Pacific Telephone and Telegraph Company v Public Utilities Commission (1965) 62 Cal 2d 662-663 the California Supreme Court upheld the Commission's procedures.

The most recent and extensive examination of this issue took place in a supplemental phase of A.55492, another general rate proceeding of Pacific. D.90362 dated June 5, 1979 covered the results of that examination. In that decision, Conclusion of Law 2 stated:

> "Future license contract proceedings should be separate investigations conducted every few years with the results being applied to Pacific's rate increase applications. Pending completion of these periodic determinations, the last adopted ratemaking adjustment should be applied in Pacific's rate cases." (Mimeo. p. 113.)

However, in a parenthetical statement to the dicta in that decision, the Commission stated "(This should not limit, however, the staff from recommending adjustments in other areas of the license contract, not covered by the most recent investigation)."

In this proceeding, the staff characterized its study on license contract costs as basically an update of information developed for A.55492. However, with the conclusion and statement of the Commission noted above in mind, the staff maintains it is not precluded "from looking in other areas of License Contract not covered by the most recent investigation such as new General Departments, reorganized General Departments or activities not previously reviewed." (Exh. 262 § II page 4-3.) The staff believes a fresh look at some of the information surrounding the license contract matters is required in this application because of (a) the realignment of Pacific's and AT&T's management announced last summer in response to the FCC Computer II decision which requires unbundling of certain operations by March 1982, (b) a substantial increase in operating system costs charged to the OTCs through cost-sharing agreements involving Bell Labs' business information systems organization, and (c) the need for an update of previous staff calculations designed to limit Western's profits on sales to Pacific to the return authorized Pacific by the Commission.

Pacific believes the staff study is not an update but a thorough restudy and moved to have the staff study and the license contract matter considered in a separate proceeding based on the conclusion of the Commission in D.90362. Pacific's motion to sever was denied by the ALJ; we affirm that ruling.

The staff stated that although some adaptations were necessary because of changing conditions, their report generally followed the basic principles set forth in D.90362. According to the staff, that decision disallowed, for ratemaking purposes, license contract expenses charged to Pacific which the Commission concluded were of primary benefit to AT&T shareholders or of primary benefit to the Bell System products designed to compete in the marketplace with those of other manufacturers and found that those costs should not be borne by California ratepayers.

License contract expense will be discussed under five general areas:

1. Bell Labs Expenses.
2. AT&T General Department Expenses.
3. Return on Investment (ROI) for the 195 Broadway Corporation.
4. Bell Labs Business Information Systems.
5. The Western Electric Adjustment.

Table 14 contains the pertinent information for discussion in this section. Pacific and staff agree that total estimated billings to Pacific under the license contract agreement for 1981 will be $134,476,000. In conformance with its understanding of D.90362, Pacific recommends adjustments to that figure of $46,121,000 for a ratemaking allowance of $88,355,000 for the total Pacific Company. On the other hand, the staff recommends the adjustments under D.90362 of $59,854,000 and an additional adjustment of $19,107,000 because of AT&T and Pacific organizational realignments related to the FCC Computer II decision; this brings the staff's total adjusted billing to $55,515,000, $32,840,000 less than Pacific's. In addition, the staff recommends an adjusted billing of $18,441,000 for BIS of Bell Labs, and a Western Electric adjustment of $139,069,000 to rate base and $24,325,000 to expenses.

Diagram A will help the reader sort out the interrelationships among AT&T, Bell Labs, Western, and Pacific which are necessary to understand the adjustments adopted in this decision for expenses charged Pacific by AT&T, billings to Pacific by Bell Labs, and the Western Electric adjustment.

TABLE 14

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Summary of Adjustments
Affiliated Relationships
Estimated 1981
(Dollars in Thousands)

| Item | General Department | Bell Labs | ROI | Total |
|---|---|---|---|---|
| **License Contract Expense** | | | | |
| Estimated Billable to Pacific | $ 79,770 | $ 46,167 | $ 8,539 | $ 134,476 |
| Pacific's D.90362 Adjustments | (22,118) | (22,294) | (1,709) | (46,121) |
| Pacific's Adjusted Billing | 57,652 | 23,873 | 6,830 | 88,355 |
| Staff's D.90362 Adjustments | (30,395) | (24,650) | (4,809) | (59,854) |
| Staff's Adjusted Billing | 49,375 | 21,517 | 3,730 | 74,622 |
| Staff's Realignment Adjustment | (18,063) | - | (1,044) | (19,107) |
| Staff's Adjusted Billing | 31,312 | 21,517 | 2,686 | 55,515 |
| Difference: Pacific-Staff | 26,340 | 2,356 | 4,144 | 32,840 |
| Adopted Billing | 31,300 | 22,700 | 3,500 | 57,500 |
| **BTL-Business Information Systems** | | | | |
| Estimate Billable to Pacific | | | | 20,099 |
| Staff Adjustments: | | | | |
| Increase to Reflect Updated BIS Expense Levels | | | | 482 |
| Deduction for Projects not Used by Pacific | | | | (990) |
| Deduction to Reflect Revenue from Sale of BIS Products | | | | (256) |
| Deduction to Reflect Revenue from Sale of UNIX Programs | | | | (894) |
| Staff Adjusted Billing | | | | 18,441 |
| **Western Electric Adjustment** | | | | |
| Rate Base and Expense Adjustments for Pacific's Purchases from Western: Rate Base Reduction | | | | (139,069) |
| Expense Reduction | | | | (24,325) |

(Red Figure)

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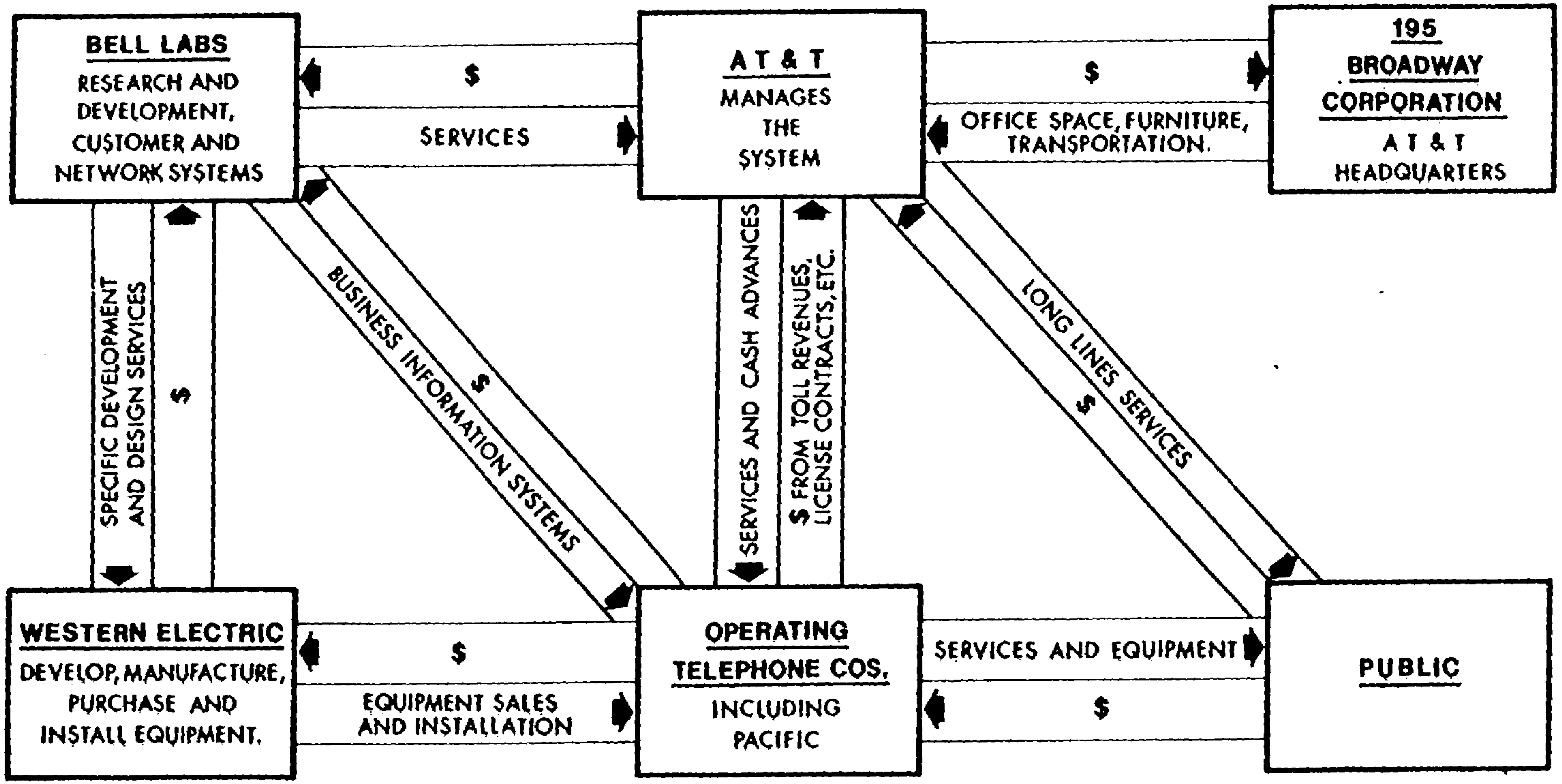
Diagram A




BELL SYSTEM RELATIONSHIPS

Taking first the $2,356,000 difference for Bell Labs on Table 14, it is made up of several differences between Pacific and staff estimates for research and systems engineering (R&SE). Table 15 is a summary of the two estimates for 1980 and 1981. Pacific and staff estimates for 1980 are almost the same. The staff's adjustments for 1980 which it supported with an extensive study (Exh. 261 § III) may be summarized as follows:

a. Procedures for ensuring the proper allocation of expenses to Pacific are not reliable because the supporting detail for cases does not enable Bell Labs to track costs by class of work. The staff has adjusted the 1980 class of work assignments to reflect more accurately the nature of the work performed. This adjustment reduces Pacific's portion of Bell Labs 1980 expense by $500,000.

b. Bell Labs refused to disclose certain aspects of its R&SE work due to "preannouncement problems". Because the staff was not able to review this work, it recommends that the related expenses be disallowed. This would reduce Pacific's portion of Bell Labs 1980 R&SE expense by $1,150,000.

c. Bell Labs incurred $5,449,300 of antitrust-related expenses in 1979. The staff recommends that 50% of such expenses allocated to R&SE cases be disallowed. This adjustment would reduce Pacific's portion of Bell Labs 1980 R&SE expenses by $158,000.

d. The staff has determined that 65% of Bell Labs R&SE work is product-related and should be funded by Western. However, in keeping with D.90362, the staff recommends that 50% of all R&SE expenses (after excluding patent expenses, and after staff adjustments to R&SE expenses) should be disallowed. This adjustment would reduce Pacific's portion of Bell Labs 1980 R&SE expenses by $19,626,000.

TABLE 15

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Bell Labs R&SE Expenses
Estimated 1980 and 1981 Test Year
(Dollars in Thousands)

| Year | Item | Staff | Utility | Utility Exceeds Staff |
|---|---|---|---|---|
| 1980 | Estimate | $40,575 | $40,515 | $ (60) |
| | Adjustment | 21,014 | 19,565 | (1,449) |
| | Adjusted | 19,561 | 20,950 | 1,389 |
| 1981 | Estimate | 44,632 | 46,167 | 1,535 |
| | Adjustment | 23,115 | 22,294 | (821) |
| | Adjusted | 21,517 | 23,873 | 2,356 |
| | Adopted | 22,684 | | |

(Red Figure)

We will adopt Item a. Item b apparently represents new products under development which are competition-sensitive. We will not allow expenses which cannot be reviewed by our staff.

Although we will adopt Items c and d, they will require a minor adjustment because there is an apparent error in the staff's method of calculating the disallowances. Staff recommends that of the $316,000 billed to Pacific by Bell Labs for antitrust expenses, one-half or $158,000 should be disallowed. However, the computation used by the staff to accomplish this disallows 75% of the $316,000, so the staff adjustment should be reduced by one-fourth of $316,000 or $79,000. Otherwise the staff's 1980 estimates for total expense and the adjustment are reasonable and will be adopted.

For its 1981 estimate, the staff applied a 10% factor to its 1980 estimates for a total adjusted amount of $21,517,000 (Table 15). Pacific estimated 1981 by a forecast method consisting of a 10% inflation factor and a 5% growth rate. The staff ignored the 5% growth rate because it believes Bell Labs did not justify it; where management decisions can play a major role in setting expenditure levels it is the staff's position that it is incumbent on the utility to show that expenses are just and reasonable. However, by any standards contained in this record on growth, 5% is a reasonable rate. We will adjust the staff's 1980 estimate by the $79,000 previously discussed and bring it forward to 1981 by a factor of 1.10 x 1.05. That calculation is (19,561,000 + $79,000) x 1.10 x 1.05 = $22,700,000.

The differences in the general department and 195 ROI estimates may be summarized as follows:

TABLE 16

| | General Department | 195 ROI | Total |
|---|---|---|---|
| Pacific Allowance | $57,652 | $6,830 | |
| Staff Allowance | 31,312 | 2,686 | |
| Difference | 26,340 | 4,144 | $30,484 |

The approximate differences between Pacific's and staff's estimates are because the staff:

a. Disallowed $600,000 for product-related activities which Pacific and AT&T would not discuss with the staff.

b. Disallowed 50% of all antitrust activities. Pacific's estimate allowed 50% of U.S. Department of Justice (Justice) antitrust costs and 100% of all other antitrust activities. Difference: $1,600,000 for 1981.

c. Applied a rate base methodology consistent with D.90362 in calculating 195's return on investment rather than an overall composite rate developed with June 30, 1976 estimated data. Difference: $3,100,000 for 1981.

d. Allocated overheads to direct general departments consistent with D.90362; applied D.90362 disallowed activities on a departmental basis rather than through an overall composite rate. The individual departmental basis was selected because AT&T has undergone major departmental changes since D.90362 and because individual departmental activities do not increase in the same proportion as the overall budget. Difference: $6,000,000 for 1981.

e. Reflected in the 1981 estimate the effect of AT&T's realignment of its general department effective September 1, 1980. The purpose of the realignment is to ensure effective management of the transition to a new administrative structure in line with current regulatory and Legislative policies of expanding competition in the telecommunications industry. The 1981 adjustment totaled $19,100,000.

Item a, the $600,000, is similar to the disallowance previously discussed for Bell Labs and will be adopted. If they do not want to tell us what the expense is for, we will not allow it.

The $1,600,000 additional disallowance for antitrust activities recommended by the staff is an expansion of previous disallowances by the Commission. Additional comments on this issue are contained in the discussion on the staff's audit report which follows in the section on other issues.

The major suits being defended by the Bell System are:

1. The Justice suit to divest AT&T of Western.
2. The Litton suit which alleges violations of the Sherman Antitrust Laws.
3. Various other cases alleging patent infringements or other restraints of trade by AT&T, Western, and various OTCs, other than Pacific.

The Justice suit was discussed at length in the staff's "Report on the Affiliated Relationship of the Pacific Telephone & Telegraph Company with Bell Telephone Laboratories, Inc., AT&T general departments, 195 Broadway Corporation", dated August 26, 1977, Exhibit 286 in A.55492. The staff claims that in A.58223, the Commission carried forward its findings in D.90362 which disallowed 50% of the Justice suit defense. This position was a carryover from a "Phase I" decision in A.55492. The Commission stated "we will keep watching developments in this suit to see if it is necessary to reevaluate this percentage at a later date..." (D.88232, p. 200.)

Staff maintains that the Litton suit, which alleges violation of the Sherman Antitrust Laws, and other cases as well, which allege patent infringements or restraints of trade by AT&T, Western, and other OTCs, are similar to the Justice allegations.

The regulatory treatment of such antitrust suits should be consistent; both the ratepayers and stockholders stand to win or lose on specific allegations. Therefore, it is reasonable to expect the ratepayers as well as the stockholders to share the cost equally. The staff recommends that ratepayers incur 50% and stockholders 50% of all antitrust suits. On this record a comparison of the Justice and Litton cases can be made from Exhibit 265 and Item 34. The substantial similarity in these two cases is readily apparent; we will accept the staff recommendation.

Item c involves 195 which is 100% owned by AT&T. The function of 195 is to provide building space, office equipment, and transportation for AT&T. This corporation was formed in order to comply with the telephone franchising laws of the State of New York which prohibit two telephone utility companies from owning property in the same service area. Because New York City is served by the New York Telephone Company, 195 had to be created by AT&T to conform with New York law. The majority of the buildings and all of the furnitures and fixtures of AT&T are owned by 195. In addition to providing offices and furniture, 195 attends to AT&T's needs for motor vehicles, aircraft, leasehold improvements, maintenance, and janitorial services.

As compensation for its services, 195 bills AT&T for the expenses incurred at cost. No profit is billed by 195 to the general department of AT&T. However, AT&T does include a return on its 195 investment as well as on its Bell Labs' investment through license contract billings to the OTCs. The return is computed on AT&T's average total capital. This method varies from the Commission's traditional used and useful rate base approach for a regulated utility. In D.90362, the Commission ruled that a utility rate base calculation for 195 is the appropriate method for license contract purposes. Because the functions of 195 have not changed the utility regulatory rate base approach for 195 is still applicable. In following through on that approach, it is necessary to allocate 195's return on investment between allowable and disallowable activities for ratemaking purposes. This is required so that Pacific's ratepayers will not be unduly burdened with a return on investment devoted to disallowable activities.

Table 17 develops the net required return recommended by the staff of $2,686,000. It should be noted that although Table 17 develops the full $2,686,000, $1,444,000 of that total will be included in the discussion of Item e, the realignment issue, which follows. We will adopt $3,500,000 as the return on investment for 195 which reflects the 12.91% return adopted in this decision.

TABLE 17

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Development of Staff's ROI
195 Broadway Corporation and Bell Labs
For the 1981 Test Year
(Dollars in Thousands)

| Item | 1981 |
|---|---|
| 195 Broadway Corporation | |
| Plant in Service | $494,276 |
| Less Depreciation, Amortization | 97,350 |
| Net Plant in Service | 396,926 |
| Plant Held for Future Use | 9,880 |
| Madison Avenue Land | 24,000 |
| Interest During Construction | 17,369 |
| Working Cash | 5,592 |
| Less: Deferred Federal Income Tax | 45,745 |
| Total | 408,022 |
| Less Deductions for Nonlicense Contract Activity: | |
| Western Electric and Nonlicense | 11,070 |
| Cost-sharing Agreements | 28,072 |
| Investor Interest and Product Related | 140,691 |
| Realignment Related to Detariffed Items | 83,472 |
| Total Deductions | 263,305 |
| 195 Broadway Corporation Rate Base | 144,717 |
| Bell Telephone Laboratories | |
| AT&T Investment in Bell Labs | 212,394 |
| Less: Investor Interest, Product Related | 110,445 |
| Net Bell Labs Investment | 101,949 |
| License Contract Investment | 246,666 |
| Allocated % to Pacific | 9.84% |
| Total Investment | 24,272 |
| Rate of Return (Pacific Authorized) | 10.25% |
| Return on Investment | 2,488 |
| Federal Income Tax and ITC Net | 597 |
| Royalties | (399) |
| Net Required Return | 2,686 |

(Red Figure)

The $26,340,000 difference between Pacific and staff shown on Table 14 for the general department includes $18,063,000 involved with the staff's recommendation on the realignment adjustment and the above-mentioned $1,444,000 which will be discussed under Item e. Also included in the $26,340,000 are the $600,000 discussed in Item a above and the $1,600,000 discussed in Item b. That leaves approximately $6,000,000 for discussion under Item d.

Table 18 is a comparison of Pacific and staff general department estimates. It also shows the subdepartments involved in the general department operation and billable amounts to all OTCs and to Pacific for 1981.

TABLE 18

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Comparison of Pacific's and Staff's
General Department Estimates
For the 1981 Test Year
(Dollars in Thousands)

| Line No. | Item | Billable Amount: Total Licensees (a) | Billable Amount: Pacific (b) | Estimate: Pacific (c) | Estimate: Staff (d) |
|---|---|---|---|---|---|
| 1 | Executive | $ 9,340 | $ 1,077 | | |
| 2 | Federal Regulatory Matters | 4,007 | | | |
| 3 | Secretary | 1,607 | 162 | | |
| 4 | State Regulatory Matters | 7,536 | 390 | | |
| 5 | HRD - System Staff | 22,858 | 2,733 | | |
| 6 | Public Relations and Employee Information | 19,983 | 2,155 | | |
| 7 | Legal | 11,031 | 308 | | |
| 8 | Comptrollers | 37,111 | 3,929 | | |
| 9 | Treasury | 32,426 | 2,116 | | |
| 10 | Administrative Services | 169,524 | 17,048 | | |
| 11 | Planning and Administration D | 71,201 | 3,692 | | |
| 12 | Public Affairs | 5,248 | 526 | | |
| 13 | Labor Relations, Corporate Personnel and Policy Seminar | 11,605 | 1,485 | | |
| 14 | Tariffs and Costs | 29,908 | 3,197 | | |
| 15 | Business Services | 19,424 | 2,336 | | |
| 16 | Business Marketing | 51,015 | 5,175 | | |
| 17 | Residence Marketing, Sales and Service | 26,336 | 2,853 | | |
| 18 | Staff | 23,244 | 2,424 | | |
| 19 | Network Planning and Design | 17,634 | 1,753 | | |
| 20 | Network Services | 31,801 | 3,287 | | |
| 21 | Business - Other | 712 | 78 | | |
| 22 | Residence - Other | 17,485 | 1,872 | | |
| 23 | Network - Other | 804 | 78 | | |
| 24 | General Planning and Corporate Matters | 2,580 | 186 | | |
| 25 | Staff-Chief Financial Officer | 2,542 | 215 | | |
| 26 | Staff-President | 1,917 | 169 | | |
| 27 | Staff-Data Systems | 5,942 | 515 | | |
| 28 | Financial Management | | | | |
| 29 | Undistributed Expense | 207,086 | 18,590 | | |
| 30 | Subtotal | 848,390 | 79,769 | 57,652 | 17,710 |
| 31 | Realignment Overhead | | | | 9,561 |
| 32 | Amortization of Moving Expense | | | | 47 |
| 33 | Antitrust | | | | 3,994 |

The adjustments made to the license contract charges to Pacific by AT&T for general department billings involve two factors: (a) investor-interest costs and (b) product-related costs. The Commission's policy which has been long-established[8/] is that it will not recognize for ratemaking purposes expenses which a parent or holding company incurs for its investors which are passed on to regulated utility companies as part of a management or service agreement. The following is a brief list of investor-interest-type expenses:

a. Financial Reports to Stockholders.
b. Payment of Dividends and Bond Interest.
c. Maintaining Stock and Bond Records.
d. Annual Meetings of Stockholders.
e. Correspondence with Stockholders.
f. Legal Actions to Protect Investor Interests.
g. Advertising Designed to Promote Corporate Image.
h. Directors' Fees.
i. Auditors' Fees.
j. Consolidation of Records and Reports.

Product-related costs are incurred by AT&T, Bell Labs, and Western through product-development activities. In order to coordinate the product-development process, product teams are formed from personnel of the three entities. The expenses incurred to support a product team from AT&T are charged to the licensee companies as license contract expenses. The expenses of Western's team members are recovered through Western's sale of products, and the expenses of Bell Labs are recovered partly from licensee contracts and partly from Western.

The staff claims that during its last audit, product teams and their related product-development costs were easily identified.

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8/ Pacific decisions as follows: 48 CPUC 11, 62 CPUC 848, 69 CPUC 60, D.90642 dated June 5, 1979 in A.55492 and C.10001.

However, as a result of the reorganization of the AT&T general department, which is discussed later in this section, the use and role of interdepartmental product teams has taken on a greater significance, making it more difficult to directly determine product-development costs.

In the staff report, those departments which are involved in the product-development process at AT&T are identified. Using the philosophy from D.90362, for departments containing product-development costs which are of primary benefit to AT&T and its shareholders, the staff adjusted for ratemaking purposes those departments charging product-development costs to license contract expenses. This is the major staff departure from the last staff study of license contract expenses.

Staff's Exhibit 262 analyzes each of the subdepartments of the general department of AT&T for investor-interest costs and product-related costs. Based on that analysis the staff recommended what it believes are the appropriate amounts for each subdepartment to be excluded from the license contracts agreement. We will adopt the staff recommendations for this decision.

Realignment Adjustment ($19,107,000)

Shortly after the staff prepared its preliminary draft report, a Bell System press release dated August 20, 1980 announced a major realignment of responsibilities at AT&T headquarters to become effective September 1, 1980; this realignment split the organization into two parts. One would be responsible for the regulated basic telecommunication services and the other for the future unregulated enhanced services and sales of customer premise equipment.[9/]

The staff claims that despite the basic changes that AT&T's September 1, 1980 realignment of its general department will have on the focus and direction of activities as a result of deregulation, no changes have been proposed in license contract agreements with the OTCs. The realignment of the AT&T general department and its impact on license contract costs passed through to Pacific is the major item addressed by the staff in a supplement to Section II of Exhibit 262. Figure A is a sketch of the new organization taken from staff Exhibit 262, Section II, p. 5-4. As can be noted, the September 1, 1980 realignment separates AT&T's general department into three primary activities:

1. Corporate staff activities.
2. Regulated activities.
3. Prospectively detariffed/unregulated activities.

In the staff's opinion ratepayers of regulated services should not pay the costs incurred by AT&T for setting up a wholly new enterprise that will take over the detariffed/unregulated activities of AT&T in March 1982 under the current FCC Computer II decision. The staff believes these costs should be charged either to AT&T shareholders or be deferred and recovered in pricing the prospectively detariffed/unregulated enhanced services and telecommunications products. Therefore, the staff recommends disallowance of all expenses of the prospectively detariffed activities section.

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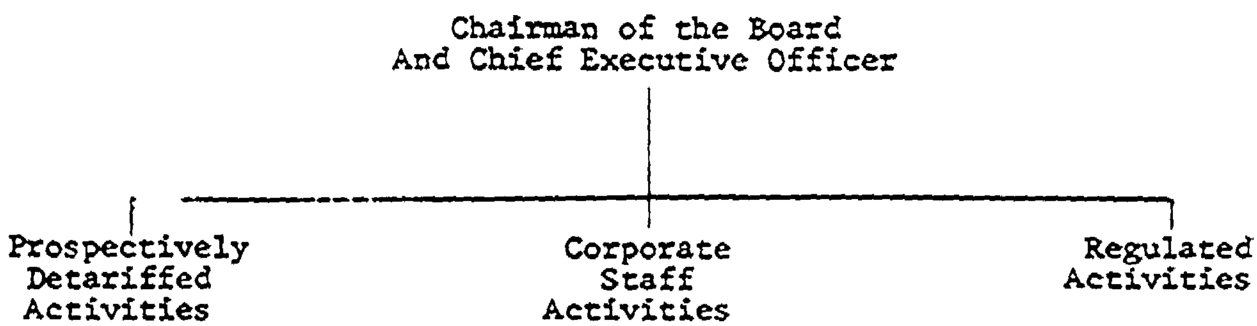
9/ The FCC in its final decision in Docket 20828, (1980) 80-628, (Computer Inquiry II) stated "the term 'enhanced service' shall refer to services offered over common carrier transmission facilities used in interstate communications, which employ computer processing applications that act on the format, content, code, protocol, or similar aspects of the subscriber's transmitted information; provide the subscriber additional, different, or restructured information; or involve subscriber interaction with stored information."

Pacific concedes there should be an adjustment but claims it should be $2,491,000, not $19,107,000. We note that by a publication in the Federal Register dated March 25, 1981, AT&T submitted a preliminary report in response to paragraph 105 of the reconsideration order in Docket 20828 released December 30, 1980 by the FCC. Paragraph 105 had required AT&T to provide the FCC with certain financial information and to submit a plan describing accounting methodology for the interim expenses relating to the provision of enhanced services. Attachment C to the AT&T preliminary report contains AT&T's plan for reporting these interim expenses. The FCC established a comment cycle to enable interested parties to submit their comments relating to the adequacy of the plan proposed in Attachment C. We comment further on this matter later in this decision and indicate some intermediate actions we will require Pacific to take. In the meantime for this decision, we will adopt the staff estimate as being reasonable.

* * *

FIGURE A

THE AMERICAN TELEPHONE AND TELEGRAPH COMPANY



Flow-through of Product-related
Disallowances to Western

Another major issue between the staff and Pacific relates to Pacific's request that it be allowed to pass on to its ratepayers those license contract costs previously disallowed as "product-related" in D.90362. To accomplish this Pacific proposes an adjustment to increase its 1981 rate base by $55 million and 1981 operating expenses by $7 million. The corresponding gross revenue requirement for this step would require about $20 million.

In D.90362 the Commission concluded that expenses of primary benefit to the process of developing products designed to compete in the marketplace with those of other manufacturers should be borne by the manufacturing company by including them in the price of its products and not paid for through license contract charges. The Commission, therefore, disallowed license contract charges pertaining to product-related costs and 50% of AT&T's marketing costs. For the same reason, it also disallowed Bell Labs research and development expenses charged to Pacific through license contract costs. The staff claims the decision contained no suggestion that Pacific would be authorized to recover the disallowed license contract charges by adjusting Western's net income.

Pacific now requests authority to pass on the disallowed costs to Pacific's ratepayers through the Western Electric adjustment. The staff claims that in proposing its product-related adjustment, Pacific referred to its understanding of the staff's position in A.55492 that product-related expenses should be borne by the manufacturing company rather than the OTCs. Therefore, Pacific reduced Western's net income by the disallowed license contract product-related costs and made no further analyses or studies. The effect of this, claims the staff, is to immediately pass on to Pacific's ratepayers the disallowed costs. The staff's position is still that product-related costs should be reflected in Western's pricing not as a ratemaking adjustment. The reason for this is that a product should reflect its true economic cost so buyers will have relevant information in making meaningful price comparisons between products of all manufacturers. If Pacific pays part of the development costs through the charges from AT&T, which eventually get back to Western in the form of subsidized costs, then the products of Western are subsequently underpriced and may look more attractive than those of a competitor which Pacific might purchase from.

In summary, the staff made four points:

1. The product-related license contract charges disallowed in prior proceedings reflect costs that should have been included in the prices of Western's products rather than in license contract charges.

2. There is no assurance that Pacific actually purchased the specific Western products whose prices were affected by the incorrect cost allocations through the license contract.

3. Even if it were shown that Pacific actually purchased the Western Electric products whose prices were affected by the incorrect cost allocations, there is no way of measuring how the pricing differences influenced Pacific to purchase Western products in lieu of products of competitors.

4. As a matter of regulatory policy Pacific should not be rewarded for being permitted to recover charges which the Commission previously found to be improper simply by changing the method of collection.

The staff recommends and we concur that the disallowed license contract product-related costs be reflected in Western's pricing practices and that Pacific's request to reduce Western's net income by the disallowed license contract product-related costs without reflecting such costs in the pricing of products should be denied.

Bell Labs Business
<u>Information Systems</u>

In 1967 Bell Labs in conjunction with AT&T and the OTCs began a program of research and development of BIS. These systems are essentially software packages prepared by Bell Labs for use by the OTCs to gather and analyze data concerning their day-to-day operations, allow more efficient administration of operations, and provide improved plans for future operations and services. The costs of these programs are charged directly to the OTCs through a BIS agreement. This is done by Bell Labs' charging AT&T for the cost of the studies and AT&T in turn billing the OTCs through the license contract agreements.

The staff's investigation of these charges included interviews with Bell Labs' and Pacific's employees, data requests, and review of historic information and recent decisions dealing with BIS. The examination involved investigation of the budgeting process and funding relating to BIS programs.

As a result of its review the staff recommends the following adjustments be made for this rate proceeding. The adjustments would be a net reduction to Account 675, Other Expenses, of $1,658,000 for 1981.

a. An increase of $482,000 to Pacific's allocated share of BIS expense to reflect updated BIS expense levels and an increase in Pacific's portion of total Bell Labs' BIS expenses from 11.26% in 1980 to 11.53% in 1981.

b. A reduction of $990,000 to Pacific's allocated share of BIS expenses to reflect the expense allocated for the DIR/ECT project including associated support and common language development. Pacific has no current plans to use this project and has its own similar program in operation.

c. A reduction of $256,000 to Pacific's allocated share of BIS expenses to reflect the revenue obtained from sale of BIS products.

d. A reduction of $894,000 to Pacific's allocated share of BIS expenses to reflect the revenue which should be received and allocated to Pacific for the sale of the BIS-developed program, UNIX (a Bell System trademark), which Bell Labs will contribute to universities. Bell Labs has in the past contributed this program to 400 universities. These contributions are disallowable for ratemaking purposes.

We will accept the staff's recommendation for Item a.

For Item b the staff's review disclosed that several programs being developed under the BIS agreement are not scheduled to be installed by Pacific either in the near future or perhaps not at all. In several cases Pacific had programs already in operation that were similar to the planned BIS programs. Therefore, by being a part of the BIS agreement, Pacific in some cases is paying twice for initial development of certain systems, and paying for systems which it will never use. The staff reviewed one of these programs in depth, the so-called DIR/ECT program (DIRectory projECT). The staff determined that Pacific's allocated share of this program for 1981 is $990,000 and therefore recommends that that amount be disallowed. We concur.

For Item c several programs developed by Bell Labs under the BIS agreement are sold to non-Bell System companies. These sales are handled through Western which acts as an agent for Bell Labs and the OTCs. The revenues from these sales minus the fee charged by Western are allocated back to the OTCs based on the same percentages of plant and expenses used to allocate the BIS expenses. The staff estimate of revenues for 1981 from this program is $2,222,000. Pacific's allocated share of those revenues would be $256,000. A staff analysis of the Pacific work papers for Account 675 revealed that these revenues were not reflected in the 1981 test year estimates. Therefore, the staff recommends the account be reduced by $256,000 for 1981 for revenues received for the sales of BIS-related products. We adopt this estimate.

Concerning Item d, further investigation by the staff revealed that a BIS-related product, UNIX, which is offered for sale through Western has been donated to at least 400 universities over the past several years. The staff recommends that the revenues lost through the donation of these programs should be treated as a reduction from the BIS expenses similar to the revenues mentioned above.

The revenue received from the sale of UNIX products to commercial industries for 1979 was $2,034,000. The staff assumed a 10% annual growth rate for 1980 and 1981. The estimated commercial revenues by that process for 1981 are $2,461,000. UNIXs installed as of August 1980 totaled 503 commercial and 1,583 at universities. The staff assumed an equal average price per installation for commercial and university installations and a 3.15 to 1 university to commercial installation ratio. From that it concluded the revenues Bell Labs would receive if it sold the programs to the universities instead of contributing them would be $7,753,000 for 1981. Pacific's allocation of these revenues would be $894,000 which is the reduction recommended by the staff. We view this issue as similar to our policy on dues and donations. In this case, Pacific is foregoing revenues it might otherwise receive to the advantage of the ratepayers for a product whose development was paid for by ratepayers. We adopt the staff recommendation.

Western Electric Adjustment

As noted earlier AT&T owns about 90% of the voting stock of Pacific and all of the stock of Western. Since the Commission was created in 1912 it has concerned itself with affiliated interests such as that typified by the AT&T-Western-Pacific relationship and its impact on the cost of services furnished to the public. Over the years, there have been many Commission decisions relating to the effects of affiliated companies on the operations of public utilities. Many of these have withstood reviews by the various courts and the result has been support of the principle adopted by the Commission that a company controlling a public utility cannot profit from that holding in excess of the profit that would accrue if the rate of return granted the utility for ratemaking purposes were applied to the controlling company. In 1949, in Pacific's second application after World War II, the Commission in an interim decision determined that Western should not earn a return greater than Pacific:

> "We hold that Western Electric is entitled to no greater return on its sale to applicant than applicant is entitled to as against its ratepayers, which we have found to be not over 5.6 percent." (D.42530 dated February 23, 1949 in A.29854, 48 CPUC 487, 493.)

The above principle has been upheld numerous times since and is now a firm principle used by the Commission and accepted by Pacific.

Western, in addition to being the manufacturing arm of the Bell System that produces over 190,000 different items for the system, also acts in the capacity of purchasing agent, supply department, developer through Bell Labs, storekeeper, installer, repairer, and salvager. Western maintains Bell System's equipment engineering offices to prepare manufacturing and installation specifications for telephone equipment; it manufactures most of the apparatus, equipment, cable, and wire required by Bell OTCs, acts as purchasing agent for materials and supplies which it does not manufacture such as poles, underground conduit, work equipment, special tools, office furniture, and stationery; and it also arranges for the printing of telephone directories. Western maintains facilities at convenient locations for the handling, storing, testing, repairing, salvaging, and junking of telephone company materials and supplies; it installs and rearranges central office switchboards and power equipment in large private branch exchanges for the operating companies.

Western's business is largely with the OTCs and the U.S. Government. Sales by Western in 1979 totaled $10,964,075,000. Of this total, sales to Bell System companies accounted for 93% and the remaining 7% went to the U.S. Government and others.

In 1949 the U.S. Government brought an antitrust dispute against AT&T and Western which sought, among other things, the separation of Western from the Bell System. This suit was concluded January 24, 1956 by a final judgment entered with the consent of the parties in the Federal District Court in New Jersey. This is the so-called 1956 consent decree. This judgment did not alter the fundamental relationships between AT&T and Western and between those companies and the OTCs. However, it does provide, among other things, that the business of AT&T and the OTCs shall be confined to communications activities subject to regulation, and the business of Western shall be confined to manufacturing and other activities of the kind in which Western is engaged for AT&T and its subsidiaries.

Western has a standard supply contract with the OTCs including Pacific. The contract sets forth in general terms the scope of the relationship between Western and Pacific regarding the manufacture, purchase, delivery, inspection, stockage, and return of materials; equipment specifications and installations; distributing storerooms; and other items. It also sets forth, in general, the method of pricing and the terms binding upon the companies. The present contract with Pacific was executed in 1930 and is the successor to the original 1906 contract.

Table 19 shows the net rate base and expense reductions recommended by Pacific and the staff. The primary contributor to the difference between the two estimates is the rate of return recommended by Pacific and staff for the 1981 test year. Pacific recommends 13.47% and the staff 11.50%. We will use the 12.91% adopted in the rate of return discussion.

TABLE 19

The Pacific Telephone and Telegraph Company
Western Electric Adjustments
(Dollars in Thousands)

| Item | 1981 Estimated Staff | Pacific | Adopted |
|---|---|---|---|
| Net Rate Base Deduction | $139,069 | $116,757 | $134,900 |
| Expense Deduction | 24,325 | 10,802 | 12,800 |

Rate Base

Table 20 shows the system and California intrastate rate base estimates for Pacific and the staff summarized from Tables 1 and 2. Pacific claims the difference in the estimates is because of five major errors by the staff.

1. The staff did not increase the pace of modernization although this is what Pacific is doing and is a correct policy in Pacific's view.

2. The staff erroneously combined the customer movement as part of growth and thus failed to allow for the large quantity of station equipment needed, thus underestimating by $150 million.

3. The staff made a $30 million underestimate of compensating bank balances included in the working cash; this is less than that allowed General Telephone although it is more than four times smaller than Pacific.

4. The staff's trend analysis did not reflect the current level of construction.

5. The staff underestimated the amount of rate base through the end of 1980; actual figures would have confirmed Pacific's forecasts.

TABLE 20

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Rate Base - Present Rates - 1981
(Dollars in Thousands)

Total Operations

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Telephone Plant-in-Service | $15,683,907 | $16,008,289 | $324,382 | $15,708,700 |
| Telephone Plant Under Constr. | | | | |
| Property Held for Fut. Tel. Use | 2,910 | 2,910 | 0 | 2,900 |
| Telephone Plant Acquisition Adj. | | | | |
| Working Cash Allowance | 228,165 | 303,178 | 75,013 | 170,000 |
| Materials and Supplies | 130,678 | 149,946 | 19,268 | 133,700 |
| Less: Depreciation Reserve | 2,934,645 | 2,924,140 | (10,505) | 2,935,900 |
| Less: Reserve for Deferred Taxes | 1,485,707 | 1,495,377 | 9,670 | 1,489,600 |
| Total Rate Base | 11,625,308 | 12,044,806 | 419,498 | 11,589,800 |

California Intrastate

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Telephone Plant-in-Service | $11,728,426 | $11,987,458 | $259,032 | 11,747,000 |
| Telephone Plant Under Constr. | | | | |
| Property Held for Fut. Tel. Use | 2,180 | 2,227 | 47 | 2,200 |
| Telephone Plant Acquisition Adj. | | | | |
| Working Cash Allowance | 173,250 | 229,631 | 56,381 | 129,100 |
| Materials and Supplies | 97,643 | 113,021 | 15,378 | 99,900 |
| Less: Depreciation Reserve | 2,206,853 | 2,164,230 | (42,623) | 2,207,800 |
| Less: Reserve for Deferred Taxes | 1,116,657 | 1,107,460 | (9,197) | 1,119,600 |
| Total Rate Base | 8,677,989 | 9,060,647 | 382,658 | 8,650,800 |

(Red Figure)

Rate base is an aggregation of telephone plant-in-service, property held for future use, working cash allowance, and materials and supplies, with deductions for depreciation reserve and deferred tax reserves. The detail of rate base estimates for this decision is shown on Tables 21 through 24. As can be noted from Table 20, the 1981 staff estimate for total operations is $419 million below that of Pacific. The difference is attributable to different beginning-of-period figures for plant-in-service for 1981, different 1981 program forecasts, and different forecasts for working cash and materials and supplies.

<u>Plant-in-Service</u>

| | |
|---|---|
| Pacific | $16,008,300,000 |
| Staff | 15,683,900,000 |
| Difference | 324,400,000 |

While the staff and Pacific are in agreement on plant-in-service at the beginning of 1980, the staff's view of the 1980 construction program results in a figure $104 million lower for telephone plant-in-service as 1981 begins than that used by Pacific on a total of about $15 billion. Concerning that major difference, Pacific claims the staff's forecasting methods for the various parts of the construction program for both 1980 and 1981 are subject to infirmities. It claims the staff's estimates for 1980 contained faulty methods and therefore when used as a starting point for 1981 are incorrect.

The second largest difference, $122.7 million as shown on Table 21, is caused by total 1981 weighted average net additions. This results from different estimates for the construction program in 1981.

The forecast of gross construction for 1981 is broken down into four factors:

1. Plant replacement.
2. Customer movement.
3. Modernization.
4. Growth.

The staff and Pacific estimates for plant replacement are the same. There is a $150 million difference in customer movement, a $35 million difference in modernization, and a $24 million difference in the growth factor.

TABLE 21

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Telephone Plant-In-Service
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Beginning-of-Year Balances | $14,910,300 | $15,014,626 | $104,326 | |
| Weighted Avg. Net Adds. | 897,100 | 1,019,762 | 122,662 | |
| Total Weighted Avg. Tel. Plant-in-Service | 15,807,400 | 16,034,388 | 226,988 | |
| Allocation to Nevada | (1,092) | (1,092) | 0 | |
| Plant Verification | (2,016) | (2,016) | 0 | |
| IDC Rate Adj. | (8,395) | (8,395) | 0 | |
| IDC on Short-Term Jobs | 67,164 | 67,164 | 0 | |
| IDC on Taxes on Land | (1,147) | (1,147) | 0 | |
| Subtotal Adjs. | 54,514 | 54,514 | 0 | |
| Total Tel. Plant-in-Service | 15,861,914 | 16,088,902 | 226,988 | $15,861,900 |
| Affiliated Int. Adj. | (178,007) | (80,613) | 97,394 | (173,100) |
| Recast Tel. Plant-in-Service | 15,683,907 | 16,008,289 | 324,382 | 15,688,800 |
| Adjustment - Modernization | | | | 15,800 |
| Adjustment - IDC Interest Rate | | | | 4,100 |
| Adopted Plant | | | | 15,708,700 |

(Red Figure)

TABLE 22

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Property Held for Future Use
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Prop. Held for Future Use | $ 358 | $ 358 | $ 0 | |
| IDC and Taxes on Land Adj. | 2,552 | 2,552 | 0 | |
| Recast Prop. Held for Fut. Use | 2,910 | 2,910 | 0 | $2,900 |

The customer movement portion of the capital budget is for the installation of telephones not directly related to a net gain in customers, that is, the installation of telephones for existing customers who move from one location to another. Under current practices the labor necessary to install station equipment is a capital expenditure and is included in the customer movement portion of the capital budget. Pacific claims customer movement is related to the inward movement of total telephones, not gain in telephone lines. The staff witness used telephones to estimate both the growth and customer movement factors.

The difference between the staff and Pacific's forecast for modernization in 1981 is $35 million. The staff witness agreed that a consistent use of the telephone plant index factor for all of his work papers would increase the staff's modernization forecast by $8.4 million. The staff witness testified he would maintain the 1981 modernization budget at the same level as 1980 but adjusted for inflation. Pacific claims the staff forecast for modernization, even including the $8.4 million adjustment, results in only an 8% increase for inflation. We will adopt Pacific's estimate for modernization; adjusting for phasing in during the year will increase the staff estimate by $15.8 million. The staff witness further stated that a certain portion of the company's modernization program could be deleted if necessary for Pacific to maintain its financial integrity. For instance, he suggested the corporate exchange switching program includes $97 million of discretionary projects which could be deferred without being detrimental to the program. Deferring capital expenditures would defer the need for investment capital. The staff also notes that Pacific includes $32.9 million to implement offering terminals to deaf and speech-impaired customers. In OII 70 the staff has made recommendations relative to the establishment of a deaf equipment acquisition fund and rate recovery mechanism, and believes capital expenditures for such equipment should not be included in the general rate proceeding.

Witness Craig for Pacific testified that the growth portion of Pacific's 1981 construction budget is planned to accommodate new customers as well as increased usage by existing customers. In addition, growth is also affected by inflation and the need to provide sufficient plant to ensure proper margins. In addition, Pacific proposes a corporate level contingency fund of $78.7 million which is over and above contingency allowances in the normal budgeting process. This fund has generally been assigned to the growth factor. Staff witness Mangold indicated his estimate for growth was based solely on the relationship of growth to telephone gain and inflation.

Pacific relies heavily upon 1980 as a constrained budget year and maintains it is necessary in 1981 to return to normal. However, witness Craig testified for Pacific that every year since 1964 has been a constrained year.

In summary, there are two basic factors which lead to the staff's lower estimate of construction expenditures, estimated telephone gain and capital expenditures required for each unit of gain. It appears the staff estimate is entirely consistent with its estimated test year overall business level reflected by its estimate of revenues and other expenses which are consistently lower than Pacific's; we will adopt the staff's estimate adjusted by $15.8 million.

Property Held for Future Use

Pacific and staff agree on, and we adopt, estimates of property held for future use, Table 22.

Working Cash Allowance

| | |
|---|---|
| Pacific | $303,200,000 |
| Staff | 228,200,000 |
| Difference | 75,000,000 |

There are two reasons for the difference in working cash estimates, the level of revenues, expenses, and taxes estimated by Pacific and the staff, and compensating bank balance estimates. Concerning levels of revenues, expenses, and taxes we have adopted for this decision, they have been run through the working cash calculation and adjusted accordingly for that factor.

For compensating bank balances, Pacific forecasted $41,800,000 for the test year 1981 and the staff estimated $10,000,000. The staff estimate is based on a judgment figure which is bottomed on the amount allowed Pacific in its last rate case, slightly over $7 million. The staff witness maintained he could not accurately determine the bank balances under a new accounting procedure and that in his opinion the $10 million is a reasonable amount based on past experience and a realistic balance for Pacific as required by banks. The record is not clear on this matter; we will adopt an average of Pacific's and the staff's estimates and request that Pacific and the staff provide more detailed information in the next rate case so we can make a more informed judgment. In the meantime, we will adopt the staff's working cash estimate of $228,200,000 modified by $42.2 million to reflect the adjusted level of revenues and expenses and the adopted rate of return, and by $16 million for compensating bank balances for a total adopted amount of $170,000,000.

Materials and Supplies

| | |
|---|---|
| Pacific | $149,900,000 |
| Staff | 130,700,000 |
| Difference | 19,200,000 |

For materials and supplies (Table 23) the staff estimated a reduction of $2.7 million for the cost of certain special equipment known as Circuit-Paks. The rest of the difference in working cash estimates is attributable to the staff's calculating a fixed 5% of its total estimated construction budget. Pacific claims its estimates for materials and supplies are more sophisticated than using a simple percentage of the total construction budget. However, Pacific concedes that when the 5% factor used by the staff is applied to Pacific's construction program the result for materials and supplies is very close to Pacific's own estimate.

TABLE 23

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Materials and Supplies
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Materials and Supplies | $134,052 | $150,614 | $16,562 | $134,100 |
| Circuit-Paks Adj. | (2,652) | (668) | 1,984 | |
| Adjusted Materials and Supp. | 131,400 | 149,946 | 18,546 | |
| Affiliated Int. Adj. | (722) | 0 | 722 | (400) |
| Recast Materials and Supp. | 130,678 | 149,946 | 19,268 | 133,700 |

(Red Figure)

Concerning the Circuit-Pak adjustment, based on some 1977 accounting transactions, the staff proposed and the Commission adopted in D.90642 an adjustment to the materials and supplies account of $668,000. This was done on the premise that the Circuit-Pak equipment was originally charged to maintenance expense and that later it was charged to rate base, which was improper. In this proceeding the staff proposes to increase the rate base adjustment to a total $2,652,000, the original $668,000 plus $1,984,000 additional. In rebuttal to the staff proposal Pacific presented Exhibit 338 which it claims is a full history of the issue. The exhibit shows that an accounting error was made, the error was corrected, and a field inventory made to support the correction. According to witness Dennis, Exhibit 338 illustrates that while the ratepayers may have paid for Circuit-Paks through expensing originally, they were fully compensated later when accounting records were corrected to reflect the costs of the units in the materials and supplies account and an equivalent amount removed from maintenance expense accounts. Dennis claims that in the conduct of normal operations, the 1977 and 1978 units have been removed from the materials and supplies account. Therefore, no Circuit-Pak adjustment is appropriate any longer and the $668,000 should be restored to rate base together with the $1,984,000 for a total of $2,652,000 recommended deleted by the staff. We will adopt Pacific's position on this matter.

Depreciation Reserve

As noted earlier, depreciation reserve is a derivative account; once investment has been determined the reserve is automatically determined by the depreciation rates which are agreed to by the Commission and Pacific on an annual basis. Table 24 contains the appropriate amounts for this decision together with the normalized tax reserve which is not in dispute.

TABLE 24

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Depreciation Reserve and Deferred Tax Reserve
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Begin. of Yr. Deprec. Reserve | $2,855,895 | $2,836,560 | $(19,335) | |
| Deprec. Expense | 859,923 | 897,927 | 38,004 | |
| Deprec. Clearing Accounts | 16,832 | 15,811 | (1,021) | |
| Retirements | (616,900) | (666,000) | (49,100) | |
| Gross Salvage | 55,521 | 59,940 | 4,419 | |
| Cost of Removal | (86,366) | (93,240) | (6,874) | |
| Other | 600 | 600 | 0 | |
| End-of-Yr. Deprec. Reserve | 3,085,505 | 3,051,598 | (33,907) | |
| Net Additions to Reserve | (229,610) | (215,038) | 14,572 | |
| Weighted Adds. to Reserve | 117,335 | 105,094 | (12,241) | |
| Weighted Avg. Deprec. Reserve | 2,973,230 | 2,941,654 | (31,576) | |
| Allocation to Nevada | (133) | (133) | 0 | |
| IDC Rate Adjustment | (876) | (876) | 0 | |
| IDC Short-Term CWIP Adj. | 2,084 | 2,084 | 0 | |
| Total Avg. Deprec. Reserve | 2,974,305 | 2,942,729 | (31,576) | $2,974,300 |
| Affiliated Int. Adj. | (39,660) | (18,589) | 21,071 | (38,600) |
| Recast Deprec. Reserve | 2,934,645 | 2,924,140 | (10,505) | 2,935,700 |
| Adjustment for: Modernization | | | | 200 |
| Adopted Deprec. Reserve | | | | 2,935,900 |
| Normalized Tax Reserve | 1,485,707 | 1,495,377 | 9,670 | 1,485,700 |
| Adjust for Modernization | | | | 3,900 |
| Adopted Norm. Tax Reserve | | | | 1,489,600 |

(Red Figure)

Construction Work
In Progress

The final rate base matter to be considered involves construction work in progress. By D.92366 dated October 22, 1980 in the recent General Telephone rate case the Commission included short-term CWIP in the rate base. Short-term CWIP refers to projects expected to be completed in less than one year and in Pacific's case relates to 75% to 80% of its current construction. In its brief Pacific claims that when CWIP is included in the rate base, the balance for interest-during-construction (IDC), which is capitalized, is reduced and the long-run effect is beneficial for the ratepayers because it also eliminates the payment of a return on and depreciation of such interest over the life of the asset.

The effects of including short-term CWIP in rate base are as follows:

1. Capitalized interest is removed prospectively from rate base.
2. Depreciation related to the capitalized interest is excluded prospectively.
3. CWIP is added to rate base. In this case there would be a net addition to California intrastate rate base of $542,673,000. That additional rate base would require $107,200,000 per year in additional intrastate revenue requirement.

In its brief Pacific claims the addition to rate base properly compensates the investors for funds which have already been invested in Pacific and are being used for the benefit of the ratepayer. We note that Pacific did not include this proposal in either its NOI filing or its subsequent application assuming, we suppose, a treatment similar to what we have done in the past. It was only after the General decision that Pacific brought up the matter. In D.92366 we stated that our treatment there was for a special purpose, was a marked departure from our past policy, and "those who follow our regulation should not take it as a change in our basic policy." We will not adopt Pacific's proposal.

One final matter on rate base. Pacific recommends and the staff opposes compounding of IDC for both long- and short-term CWIP. By FCC authorization (Docket 19129) Pacific began monthly compounding on January 1, 1979. We approved semiannual compounding starting January 1, 1981 (Resolution RF-4). We require Pacific to compound monthly when making refunds to ratepayers. We agree with Pacific that monthly compounding of IDC is reasonable and will adopt it effective January 1, 1981.

Adopted System
Results of Operations

Table 25 is the results of operations from Tables 1 and 2 as adjusted by the discussion in the sections of this report on revenues, expenses, and rate base, and represents the results of operations we will adopt under present rates for total California and California intrastate through the procedures described for the intrastate results in Table 7.

1980 Intrastate Results

Table 26 shows 1980 intrastate results of operations as estimated by the staff and Pacific and actual as reported by Pacific. D.91495 in A.59269 granted Pacific an interim rate increase with rates subject to refund pending a determination in this proceeding of the reasonableness of the rate increase. D.91495 established 10.25% as a reasonable rate of return for Pacific. Table 26 indicates Pacific attained an 8.95% return before the usual adjustments we make for ratemaking purposes such as affiliated interests. If we consider those adjustments and the $69.4 million discussed earlier, Pacific would not attain the 10.25%. Therefore, the rate increase granted in April 1980 was reasonable from an overall standpoint. The reasonableness of class-of-customer increases will be discussed under rate design.

TABLE 25
Page 1

The Pacific Telephone and Telegraph Company
(Dollars in Thousands)

| | Adopted Estimated Results of Operations - 1981 | | | |
|---|---|---|---|---|
| | Total Company Unadjusted | Intrastate Unadjusted | Intrastate Adjustments a/ | Adjusted |
| Operating Revenues | $ 6,326,900 | $ 4,691,000 | $ 3,400 | $ 4,694,500 |
| Operating Expenses & Taxes | | | | |
| Current Maintenance | 1,611,700 | 1,160,100 | - | 1,160,100 |
| Depreciation & Amortization | 853,300 | 640,000 | - | 640,000 |
| Traffic Expenses | 406,500 | 319,100 | - | 319,100 |
| Commercial Expenses | 708,900 | 585,300 | - | 585,300 |
| Gen. Office Salaries & Exp. | 363,400 | 285,300 | (500) | 284,800 |
| Operating Rents | 51,900 | 41,600 | - | 41,600 |
| Gen. Services & Licenses | 57,500 | 43,000 | - | 43,000 |
| Balance Other Oper. Exp. | 638,400 | 481,200 | - | 481,200 |
| Total Oper. Expenses | 4,691,600 | 3,555,600 | (500) | 3,555,100 |
| Operating Taxes - Fed. Income | 223,200 | 131,400 | 1,600 | 133,000 |
| Cal. Corp. Franch. | 33,900 | 13,100 | 500 | 13,600 |
| Social Security | 133,000 | 100,200 | - | 100,200 |
| Other | 130,500 | 97,600 | - | 97,600 |
| Total Expenses & Taxes | 5,212,200 | 3,897,900 | 1,600 | 3,899,500 |
| Net Revenues | 1,114,700 | 793,200 | 1,800 | 795,000 |
| Avg. Net Plant & Working Capital | | | | |
| Telephone Plant-in-Service | 15,708,700 | 11,747,000 | - | 11,747,000 |
| Telephone Plant Under Constr. | - | - | - | - |
| Prop. Held for Fut. Tel. Use | 2,900 | 2,200 | - | 2,200 |
| Tel. Plant Acquisition Adj. | - | - | - | - |
| Working Cash | 170,000 | 129,100 | (800) | 128,300 |
| Material and Supplies | 133,700 | 99,900 | - | 99,900 |
| Less: Depreciation Reserve | 2,935,900 | 2,207,800 | - | 2,207,800 |
| Less: Reserve for Deferred Taxes | 1,489,600 | 1,119,600 | - | 1,119,600 |
| Total Rate Base | 11,589,800 | 8,650,800 | (800) | 8,650,000 |
| Rate of Return | 9.62% | 9.17% | - | 9.19% |

(Red Figure)

a/ See page 2.

TABLE 25
Page 2

Adopted Adjustments - Intrastate
(Dollars in Thousands)

| | | |
|---|---|---|
| 1 | Revenues | $ 3,300 a/ |
| 2 | | 100 b/ |
| 3 | | 3,400 |
| 4 | Expenses (G.O.) | (500) a/ |
| 5 | = 3-4<br>= Taxable Inc. Change | 3,900 |
| 6 | = CCFT = 5 x 13.7% | 500 |
| 7 | = FIT = (5-6) x 46% | 1,600 |
| 8 | = Net Rev. = 5-6-7 | 1,800 |
| 9 | = Rate Base Change | (800) a/ |

(Red Figure)

a/ D.97247, Ex. 292 - $3,294,000 decrease in uncollectibles in G.O. = $(502); Rate Base (W.C.) = $(759)

b/ Advice Letters - Ex. 359

TABLE 26

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

1980 California Intrastate Results of Operations
(Dollars in Thousands)

| | Estimated by Staff | Estimated by Pacific | Actual |
|---|---|---|---|
| Operating Revenues | $ 4,285,568 | $ 4,367,261 | $ 4,160,288 |
| Uncollectibles | (43,315) | (53,082) | (42,803) |
| Total Oper. Revs. | 4,242,253 | 4,314,179 | 4,203,091 |
| **Operating Expenses** | | | |
| Maintenance | 1,027,373 | 1,035,334 | 1,036,577 |
| Traffic | 293,379 | 294,140 | 274,021 |
| Commercial | 489,149 | 504,957 | 493,967 |
| G & O Sal. & Exp. | 242,701 | 250,352 | 238,828 |
| Other Opr. Exp. | 461,003 | 495,733 | 502,579 |
| Subtotal | 2,513,605 | 2,580,516 | 2,545,962 |
| Depreciation Expense | 582,258 | 603,014 | 583,249 |
| Prop. & Other Taxes | 169,927 | 174,167 | 176,849 |
| State Income Tax | 32,352 | 9,730 | 61,132 |
| Federal Income Tax | 186,010 | 182,242 | 145,010 |
| Affiliated Int. Adj. | (11,871) | (8,685) | - |
| Tran. to Long Lines | (2,066) | - | - |
| Wage Contract Adj. | (2,739) | - | - |
| Net Oper. Expenses | 3,467,476 | 3,540,984 | 3,512,202 |
| Net Oper. Revenues | 774,777 | 773,195 | 690,889 |
| **Rate Base** | | | |
| Plant-in-Service | 10,684,761 | 10,735,683 | 10,514,768 |
| Prop. Held for Fut. Use | 667 | 2,328 | 704 |
| Working Cash Allowance | 154,031 | 195,894 | 212,163 |
| Materials & Supplies | 83,512 | 102,567 | 89,370 |
| Depr. Resrv. | (2,060,621) | (2,053,754) | (2,055,631) |
| Def. Tax Resrv. | (938,948) | (938,973) | (1,039,582) |
| Affiliated Int. Adj. | (87,481) | (79,608) | - |
| Tran. to Long Lines | (791) | - | - |
| Total Rate Base | 7,835,130 | 7,964,137 | 7,721,792 |
| Rate of Return | 9.89% | 9.71% | 8.95% |

(Red Figure)

Rate of Return

In reviewing this record we find one fact is very clear, Pacific's present financial ratings (Moody's A, Standard and Poor's A-) must be protected and if possible strengthened. The recent ratings history is shown on Table 27. The alternative is that Pacific may suffer higher interest costs and ratepayers higher rates in the future if the ratings are not protected. Many lenders cannot invest in B-rated bonds as a matter of law and, of course, many others will not invest in them, even though the interest may be much higher, when A and above are available. There appears to be no dispute that if downrated, Pacific will not be able to obtain all of the debt capital it needs to finance its operations. Pacific's 1981 construction budget is projected at $2.9 billion of which it must raise approximately $1.5 billion in the external capital markets. Pacific's witness Joses testified that Pacific's construction program will probably reach about $3.5 billion by 1985 putting ever-increasing pressures on capital requirements to be obtained from external markets.

Five witnesses testified on rate of return. Table 28 is a summary of their recommendations. Four of the witnesses made complete rate of return recommendations including capitalization ratios, costs of long-term debt and preferred stock, and return on common equity. Table 29, a summary of the rate of return recommendations, is reproduced from Exhibit 333.

TABLE 27

RATINGS OF THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY BONDS

| YEAR | BOND ISSUES | MOODY'S | STANDARD & POOR'S |
|---|---|---|---|
| 1973 | All Series | Aaa | AA (1) |
| 1974 | " " | Aaa | AA |
| 1975 | " " | Aaa | AA |
| 1976 | " " | Aaa | AA |
| 1977 | " " | Aa (3) | AA- (2) |
| 1978 | " " | Aa | A+ (4) |
| 1979 | " " | A (5) | A (6) |
| 1980 | " " | A | A- (7) |

(1) Rating decreased from AAA to AA May 31, 1973.

(2) October 17, 1977.

(3) December 29, 1977.

(4) June 27, 1978.

(5) January 24, 1979.

(6) September 19, 1979.

(7) October 18, 1980.

TABLE 28

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Rate of Return Recommendations

| | Equity | Overall |
|---|---|---|
| Joses - Pacific | 19.00% | 13.47% |
| Litzenberger - Pacific | 19.70 | - |
| Mowrey - Staff | 14.00 | 11.50 |
| Kroman - City of LA | 13.50 - 14.00 | 11.11 - 11.32 |
| Langsam - GSA | 12.50 - 13.50 | 10.20 - 10.60 |

TABLE 29

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Rate of Return Recommendations

| Component | Capitalization Ratios | Cost | Weighted Cost | Times Interest Coverage |
|---|---|---|---|---|
| | Joses - PT&T | | | |
| Long-Term Debt | 53.9% | 9.78% | 5.27% | |
| Preferred Stock | 5.1 | 8.06 | .41 | |
| Common Equity | 41.0 | 19.00 | 7.79 | |
| Total | 100.0% | | 13.47% | 2.56 |
| | Mowrey - Staff | | | |
| Long-Term Debt | 53.29% | 9.87% | 5.26% | |
| Preferred Stock | 5.17 | 8.08 | .42 | |
| Common Equity | 41.54 | 14.00 | 5.82 | |
| Total | 100.00% | | 11.50% 1/ | 2.19 |
| | Kroman - City of LA | | | |
| Long-Term Debt | 53.29% | 9.53% | 5.08% | |
| Preferred Stock | 5.17 | 8.00 | .42 | |
| Common Equity | 41.54 | 13.5-14.0 | 5.61-5.82 | |
| Total | 100.00% | | 11.11%-11.32% | 2.21 |
| | Langsam - GSA | | | |
| Long-Term Debt | 50.0% | 7.8% | 3.9% | |
| Common Equity | 50.0 | 12.5-13.5 | 6.3-6.7 | |
| Total | 100.0% | | 10.2%-10.6% 2/ | 2.67 |

1/ Reflects revised debt financing estimates.

2/ Based on AT&T capital structure and capital costs.

Joses for Pacific

Robert M. Joses, Pacific's treasurer, used three different methods to compute his recommendation of the cost of common equity. His first method is based on the Commission's past acceptance in D.90642 of a minimum post-tax interest coverage of 2.55 as estimated through the use of the rate of return formula. His second and third methods are based on an equity risk premium concept. Joses testified that he verified the reasonableness of his estimates by comparing his conclusions to Litzenberger's which will be discussed subsequently.

For his first approach, Joses relied on rationale used by the Commission and its staff in previous cases. He first developed a recommended year-end 1981 capital structure for Pacific; he estimated the appropriate embedded costs of debt and preferred stock at year-end 1981 and then determined that the overall rate of return would have to be about 13.44% if the 2.55 post-tax interest coverage of D.90642 were maintained. With these facts he calculated the return on equity of 18.93%. Joses testified that his approach is valid because it is based on past Commission findings and staff recommendations. Also, the 2.55 post-tax interest coverage would maintain Pacific's current credit ratings; they must be assured, according to Joses, in order for Pacific to finance its required future construction budget. Table 30 sets forth Joses' calculations for his first method.

TABLE 30

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Computation of Required Return on Equity
Based on Post-Tax Interest Coverage* Requirement
Joses for Pacific

<u>Step 1</u>: Compute weighted cost of debt

Debt as a percent of total capital = 53.9%
Embedded Cost of debt = 9.78%
Wtd. cost of debt = 53.9% ÷ 9.78% = 5.27%

<u>Step 2</u>: Compute overall rate of return required to derive the post-tax interest coverage* of 2.55 per D.90642

Overall return ÷ Wtd. cost of debt = Post-tax interest coverage* or rearranging the above equation,
Overall return = Post-tax interest coverage* x Wtd. cost of debt:

2.55 x 5.27% = 13.44%

<u>Step 3</u>: Compute weighted cost of common equity

Wtd. cost of common = Overall return - Wtd. cost of debt - Wtd. cost of preferred:

13.44% - 5.27% - 0.41% = 7.76%

<u>Step 4</u>: Compute required return on common equity

Required return on common = Wtd. cost of common ÷ Common equity as percent of total capital:

7.76% ÷ 41.0% = 18.93%

* Excludes remand interest.

Joses' second approach is an equity risk premium concept which is based on the axiom that investors expect a higher return when undertaking riskier investments. Joses believes a risk-free investment earning the maximum return over the time period for which rates would be set in this proceeding is represented by a federally insured account with a savings and loan association. During the month of March 1980 such associations offered investors 2½-year savings certificates with no minimum requirement that guaranteed an annual yield of about 12.94%. According to Joses a potential investor in Pacific's common equity must therefore expect to earn in excess of 12.94% before the investor is willing to buy Pacific's equity. Table 31 shows Joses' method of calculating the required return by his second method. As can be seen, Joses takes the return on common equity granted in A.58223 by D.90642, subtracts from it an investor's risk-free return in July 1978 to determine an equity risk premium percent. He adds back the investor's risk-free return in March 1980 of 12.94% to obtain the required return on common equity for 1981. Averaging the Commission-adopted and Pacific-requested figures Joses produces a required return on common equity of 19.34%. Joses concludes that in order for investors to be attracted to Pacific's common equity the premium in excess of the present 12.94% risk-free investment return is about 6.40% based on the average of Pacific's request and the Commission's decision in A.58223.

TABLE 31

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Required Return on Common Equity
Based on Equity Risk Premium Approach
Joses for Pacific

| | Commission Adopted | Pacific Requested | Average |
|---|---|---|---|
| Return on Common Equity per A.58223 filed 7/14/78 | 12.25% | 14.50% | 13.38% |
| Less: Investors' risk-free return in July 1978 | 6.98 | 6.98 | 6.98 |
| Equity Risk Premium | 5.27 | 7.52 | 6.40 |
| Add: Investors' risk-free premium in March 1980 | 12.94 | 12.94 | 12.94 |
| Required Return on Common Equity | 18.21 | 20.46 | 19.34 |

Joses' third method estimates cost of common equity by subtracting the cost of new debt from the return on equity the Commission allowed Pacific in the past. A summary of that calculation is shown on Table 32. By this method Joses subtracts from the Commission-adopted and Pacific-requested returns on common equity granted in A.53587 and A.58223, the cost of new debt closest to the filing dates of those two applications. This provides an equity risk premium which when added back to 15.55%, the yield to maturity of the February 1980 bond issue, gives a return on common equity of 18.68% to 20.63%.

Based on a summary of his three methods and the ones which follow by Litzenberger, discussion of which follows, Joses determines that 19.0% is a conservative minimum estimate of return on the common equity component of Pacific's capital structure.

TABLE 32

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Required Return on Common Equity
Based on Pacific's Cost of New Debt
Joses for Pacific

| Date | Application | Cost Of New Debt* | Return on Common Equity Commission Adopted | Return on Common Equity Pacific Requested** | Equity Risk Premium Commission Adopted | Equity Risk Premium Pacific Requested |
|---|---|---|---|---|---|---|
| 9/19/72 | 53587 | 7.42% | 11.00% | 12.64% | 3.58% | 5.22% |
| 7/14/78 | 58223 | 9.57 | 12.25 | 14.50 | 2.68 | 4.93 |
| Average Equity Risk Premium Since 1972 | | | | | 3.13 | 5.08 |
| Add: Yield to Maturity of February 1980 Bond Issue | | | | | 15.55 | 15.55 |
| Required Return on Common Equity | | | | | 18.68 | 20.63 |

* Yield to maturity at filing date of most recent Pacific bond issue.

** Where a range had been requested, the average of the range has been used.

Litzenberger for Pacific

Robert H. Litzenberger, professor of finance, Graduate School of Business, Stanford University, was called by Pacific to testify on a reasonable rate of return for Pacific.

Litzenberger starts from the premise that the expected rate of return on a public utility's equity should equal the expected return on the equity of other enterprises having similar risks. It is also important that a public utility maintain its credit so it continues to have access to capital markets to raise the funds required for capital investment. Therefore, the firm's return on equity should be sufficient to assure confidence in its financial conditon so it is able to maintain its credit and to attract capital on reasonable terms.[10/]

Litzenberger stated that in a regulatory jurisdiction such as California, which uses a historical cost rate base, a just and reasonable rate of return on equity is an accounting rate of return which when applied to the historical cost rate base should result in a just and reasonable market price for the utility's common stock. A company's cost of equity capital is commonly defined as the investor's expected rate of return on the market value of its equity securities. A utility's cost of equity capital has to be translated into an allowed rate of return on book value that is consistent with a just and reasonable market price for its equity. From the perspective of the utility shareholders, the only relevant result is the impact the allowed return on book value has on the market price of its equity. In Litzenberger's judgment the setting of an allowed rate of return on book value should be viewed by the Commission as the method employed to achieve a just and reasonable market price for the public utility's equity.

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10/ Some of these comments will be recognized as reflecting the Hope and Bluefield decisions.

Litzenberger further testified that publicly available information about a utility's future profits is reflected in the market price of its stock. Therefore, it would be circular to establish rates that would maintain the current price of a company's stock when that price reflects investors' expectations concerning the rates a regulatory commission will allow. Past rate decisions which are either overgenerous or confiscatory would be reflected in a high or low current stock price. If the Commission views the current stock price as the just and reasonable market value of the utility's stock, the regulatory process would be relying on its own boot straps for support without any economic underpinning. This is why the Commission should not view the current market price of a utility's equity as just and reasonable market value.

Litzenberger uses three basic approaches to estimate a fair rate of return on equity for Pacific:

1. Discounted cash flow (DCF or cash flow),
2. Capital asset pricing model (CAPM or pricing model), and
3. Comparable earnings, which takes into account changed economic conditions.

Litzenberger first uses the two market-oriented approaches, DCF and CAPM, to estimate the company's cost of equity capital. The cash flow approach produces a 19.1% cost of equity and the pricing model produces 19.2%. He then establishes a target market-to-book-value ratio of 1.23 for the company's equity. Finally he translates the cost of equity capital estimates into fair rates of return on book equity using his recommended target market-to-book-value ratio. The fair rate of return on book equity is 20.5% based on the cash flow approach and 20.6% based on the pricing model approach.

Litzenberger uses the comparable earnings approach, that is, book value, to provide a direct estimate of Pacific's fair rate of return on book equity. This approach produces a range of fair rates of return between 18.8 and 19.7%.

Based on the three approaches Litzenberger recommends a fair rate of return on equity of 19.7%, the mid-point of the range of his fair rate of return estimates.

The DCF approach is similar to the method employed by a security analyst using fundamental analysis to estimate the expected return on a common stock. The cash flow analysis estimates Pacific's cost of equity capital as being that rate which makes the present discounted value of all future cash flows expected by investors equal to the current price of Pacific's stock. Future cash flows expected by investors can be specified as the expected dividends over a fixed investment period and the expected stock price at the end of that period. Under this approach a company's cost of equity capital, the expected rate of return on its stock, may be separated into two components, a dividend yield and expected price appreciation.

Litzenberger's cash flow analysis is keyed to three assumptions:

1. Pacific's quarterly dividends per share will grow at a constant rate from one quarter to the corresponding quarter in the next year.
2. Annual earnings per share will grow at the same rate as annual dividends per share.
3. Pacific's price/earnings multiple is constant.

An important component, of course, to the cash flow approach is the future growth rate expected by investors. Litzenberger estimates this to be 4.84% based on the retention of earnings by Pacific, a ratio of .395, and the last rate of return granted by the Commission on equity capital which was 12.25%. His estimate of a growth factor of 4.84% is the retention ratio, .395, times the return on equity, 12.25%.

Litzenberger's estimate of Pacific's cost of equity capital using his quarterly discounted cash flow model (formula), the 1979 quarterly dividends of 35¢ per share, the March 21, 1980 closing stock price of $11, and the 4.84% estimate of the consensus growth rate, is 19.1% per annum. He believes this to be a conservatively low estimate. Using Pacific's December 31, 1979 book value of $21.68 per share and its March 21, 1980 closing price of $11, the current market-to-book-value ratio is .51.

Litzenberger converts the 19.1% estimate of Pacific's cost of equity capital into a fair rate of return on book value that would result in a just and reasonable market price for Pacific's stock. This calculation is done as follows: Litzenberger recommends a target market-to-book-value ratio of 1.23. To translate his estimates into fair rates of return on Pacific's book value requires an estimate of the expected rate of growth in net income for Pacific. The higher the rate of growth used, the lower the upward adjustment to the cost of equity capital. Litzenberger assumed a 13% growth rate in net income, an approximation of the expected inflation rate implied by the current interest levels. The DCF estimate of the cost of equity capital, 19.1%, translates into a fair rate of return on equity of 20.5% by the following equation:

$$1.23\ (19.1 - 13.0) + 13.0 = 20.5\%$$

Litzenberger stated the CAPM, or pricing model, method is a theory which relies on the relationship between expected rate of return and risk on securities. Investors are assumed to like expected return and be averse to risk. Because they do not like risk, they diversify their investment portfolios. The investor, therefore,will be concerned about the risk on an individual security which cannot be eliminated through such diversification. This non-diversifiable or systematic component of the risk of an individual security is measured by its "beta". A stock's beta indicates how closely its return moves with the return of the market as a whole. The rate of return on a stock with a beta of 1.0 is expected to move in unison with the market. The rate of return on a stock with a beta of 0 moves randomly with respect to the rate of return on the market. The rate of return on a stock with a beta of 1.5 is expected to move up or down 1.5 times the movement in the rate of return on the market. Investors who do not like risk may be enticed to invest in a stock if its expected rate of return exceeds the interest rate. The higher the beta of an individual stock, the higher the risk premium. That is, the difference between its expected rate of return and the current interest rate. That risk premium is what is required to induce an investor to hold the stock. The CAPM in its most general form predicts that risk premiums on stocks will increase linearly with betas.

For application to the pricing model method, Pacific's beta was calculated by Litzenberger over the 60-month period, January 1974 through January 1978. He used this to estimate the company's future monthly risk premium. The CAPM approach also requires an estimate of the interest rates that are expected to prevail over the initial year the pending rate decision is in force. Litzenberger chose a forward interest rate of 13.9% based on 90-day T-bill contracts that span the first year the pending rate decision is expected to be in force.

Litzenberger's pricing model calculations indicate that Pacific's cost of equity capital is 19.2% per annum. This cost when translated to a fair rate of return on equity in the same manner as for the cash flow approach produces a return on equity of 20.6% by the following calculation:

$$1.23\ (19.2 - 13.0) + 13.0 = 20.6\%$$

Litzenberger's 1.23 factor is a simple calculation based on factual information from Pacific's financial data with one exception, it depends on what is known as the "q" ratio. q is a ratio of the aggregate market value, equity plus debt, of nonfinancial corporations to the aggregate replacement cost of their assets. In a perfect economic situation the value of q would be 1.0. Litzenberger claims there are short-run deviations from the value 1.0 however. He notes that for the first three quarters of 1979, for example, the estimate was 0.654 in the Economic Report of the President (January 1980, p. 141). Litzenberger sampled 29 nonregulated, nonfinancial firms having risks comparable to Pacific, and calculated a comparable q ratio using the replacement costs of their net plant and equipment and inventories and the market value of their publicly traded debt and equity. This comparable equity q ratio for 1978 was 0.715. Using 1979 Pacific data, Litzenberger calculated the recommended target market-to-book ratio for Pacific as follows:

TABLE 33

Calculation of the Recommended
Target Market-to-Book Ratio for Pacific

| | |
|---|---|
| Value of Equity at Adjusted Replacement Cost (000's) | $6,178,500 |
| Times: | |
| 1978 Equity "q" Ratio for Comparable Firms | x 0.715 |
| Short-Run Just and Reasonable Market Value of Equity (000's) | 4,417,628 |
| Divided by: | |
| Value of Common Equity at Historical Cost (000's) | ÷ 3,581,704 |
| Gives: Recommended Target Market-to-Book Ratio | 1.23 |

Turning to Litzenberger's book value, or comparable earnings approach, it measures the fair rate of return on equity for a utility by averaging over time the aggregate rate of return on book value for a sample of nonregulated enterprises having corresponding risks. The rate of profitability of nonregulated firms is determined by competitive forces. However, Litzenberger claims historical accounting rates of profitability are not reliable indicators of the future expected profitability. In recent months, long-term inflationary expectations and interest rates have increased dramatically, and under these conditions Litzenberger believes the comparable earnings approach provides a measure of the future fair rate of return only when it is implemented in risk premium form. This can be done by subtracting the interest rate on long-term U.S. Government bonds from the aggregate accounting rate of return for the comparable non-regulated companies. The average of these differences over time is an appropriate measure of the fair difference between a public utility's return on equity and the current interest rate on long-term government debt, and is indicative of the risk premium that nonregulated companies comparable to Pacific should earn.

Litzenberger selected 29 companies, the same 29 used under the development of his target market-to-book-value ratio of 1.23, to implement his comparable earnings approach. In selecting the 29 companies, he considered two measures of risk widely used by investors. One of these is the stock's beta, which has been discussed previously, and measures the extent to which the rate of return on common stock moves with the market in general. The second component is called nonsystematic risk and is the component of the variability of an individual stock that is attributable to movements that are unrelated to general movements in the market. Both the firm's beta and its nonsystematic risk determine the total variability of its rate of return and therefore influence the firm's risk of insolvency and its ability to attract capital. However, these two measures of risk are not the only ones to be considered. Litzenberger stated that the comparable earnings approach should also reflect measures that relate directly to the financial integrity of the firm and its ability to attract capital. Bond ratings and stock rankings are additional measures of this ability.

Litzenberger selected his 29 firms using the following criteria:

1. The size of the firm in comparison to Pacific,
2. Beta and nonsystematic risk factors, and
3. Standard and Poor's stock rankings.

Litzenberger chose 29 firms which met two out of the three criteria. Criteria used were as follows: Size was based on gross revenues of $100 million or larger; beta and nonsystematic risk were based on the requirement that a firm have a beta and nonsystematic risk within the 99% confidence interval for Pacific's comparable values; and a Standard and Poor's stock ranking of A+, A, or A-. For the years 1974 through 1978 the 29 firms earned a differential above the long-term interest rate of 7.5%. In Litzenberger's judgment the comparable earnings analysis indicates a reasonable differential between Pacific's fair rate of return on equity and the interest rate on long-term U.S. Government bonds is between 6.6% and 7.5%.

The March 22, 1980 issue of the New York Times reported the yield to maturity of the 8-1/4% U.S. Treasury Bond Issue maturing in May 2000 as 12.19%. The comparable earnings approach therefore indicates the fair rate of return on Pacific's equity is between 18.8% and 19.7%, that is, 12.19 + 6.6 = 18.8, and 12.19 + 7.5 = 19.7%.

Summarizing Litzenberger's recommendations, his cost of equity capital estimates using the DCF and CAPM approaches are 19.1% and 19.2%, respectively. He recommends in the short term a target market-to-book-value ratio of 1.23. Using this recommended value his cost of equity capital estimate using the DCF and CAPM approaches translates into fair rates of return on equity of 20.5% and 20.6%, respectively. His comparable earnings analysis indicates Pacific's fair rate of return on equity is between 18.8% and 19.7%. He recommends that 19.7%, the mid-point of the range of his fair rate of return estimates, be allowed in this case. His estimates of Pacific's future fair rate of return are heavily influenced by current long-term investor expectations concerning the inflation rate which manifests itself in interest rates and stock prices. Litzenberger conceded that long-term expectations concerning the inflation rate can change dramatically over short periods of time.

Mowrey for the Commission Staff

Terry R. Mowrey, a financial examiner with the Revenue Requirements Division of the Commission, testified on rate of return for the staff. Mowrey based his return on equity recommendations on an analysis of many factors both tangible and intangible which he claims affect the cost of equity capital to Pacific. Mowrey testified that one cannot base estimates solely on definitive formulas or precise mathematical calculations, that, of necessity, determination of return on equity capital is a judgment determination. In arriving at his recommendation he was guided by the standards set forth by the U.S. Supreme Court decisions and prior decisions of this Commission. They are as follows:

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

Mowrey stated the common equity ratio is one measure of the risk of investment in a particular company. In general, the higher the equity ratio the lower the risk to the equity investor because of the lower earnings required to pay interest expense prior to paying dividends. Mowrey testified that Pacific's debt ratio has continually increased over the last 10 years and was approximately 56% at December 31, 1979. The main reason for the sharp increase in the debt ratio over that period is because Pacific relied on long-term debt as the primary source of external financing. AT&T refused to make equity investments in Pacific until, in its opinion, the regulatory climate improved in California to an acceptable level. This forced Pacific to issue long-term debt in lieu of common stock to meet its construction budgets. AT&T revised its investment position in the spring of 1980 and subsequently Pacific issued 10 million shares of common stock in July 1980. Mowrey expects an additional $600 million of common stock equity will be issued in 1981. This should gradually increase Pacific's equity ratio to a level comparable to other telephone utilities. The continually increasing debt ratio has been accompanied by a deteriorating after-tax interest coverage because of the higher earnings required to meet interest expense requirements and maintain a particular times-interest coverage.

In order to determine a return for Pacific which he felt would be comparable to that earned on similar risk investments, Mowrey compared Pacific's earnings, performance, and financial data with other regulated telephone utilities. He selected three groups of telephone utilities for comparative purposes. The first group was 22 Bell System companies, the second, 14 General Telephone companies, and the third, 10 independent telephone companies. Mowrey chose telephone utilities because Pacific is a regulated telephone company with business and financial risks similar to those experienced by other telephone companies, especially Bell System and General Telephone companies.

Mowrey believes his recommendation of 14% on equity and 11.50% overall strikes a balance between the interests of Pacific's customers and its stockholders. Customers want good service at the lowest possible rates, and the stockholders want a reasonable return on their investment. Mowrey claims his recommended return fairly compensates the investor, allows Pacific to meet its fixed charge requirements, ensures the ability to attract future capital at reasonable rates, and at the same time does not overly compensate the equity holders compared to similar investments, thus protecting Pacific's customers.

Mowrey testified that interest coverage provided by a particular level of earnings is an important consideration in determining a fair and reasonable rate of return. Mowrey testified that a minimum of 2.2 times would be adequate to provide earnings sufficient for Pacific to meet its fixed charges requirements as well as allow for sufficient flexibility to attract future capital.

Some of the additional factors which Mowrey considered in arriving at his recommendation were:

1. Pacific is a regulated public utility engaged in a business which affects the public interest and as such must provide its services at reasonable rates.
2. Pacific's inclusion in the Bell System family makes it less risky than a business operating without such affiliation.
3. Pacific's capital structure, capital costs, and financial history.
4. Pacific's capital requirements.
5. Pacific normalizes federal income taxes for ratemaking purposes providing greater internal cash flow than companies which flow through income tax benefits to ratepayers.
6. Economic conditions - the effects of continued inflation and increases in embedded costs of capital.
7. The essential nature of Pacific's product to the public.

In response to a request of the ALJ, Mowrey agreed to furnish the Commission information on the changes in his recommendation caused by any changes in the mix of long-term debt, that is, new long-term debt issued and old long-term debt retired, prior to the date the Commission renders this decision.

<u>Langsam for General Services Administration</u>

Mark Langsam testified on rate of return for the GSA **on behalf of the Executive Agencies of the U.S. Government.**

Langsam is an economist for GSA. Langsam based his recommended return on his estimate of what would be an appropriate return for the entire Bell System. He premised his recommendation on a 50% debt structure, a 2.7 post-tax interest coverage, and an Aaa/AAA long-term bond rating. He testified that he makes these recommendations in rate proceedings frequently for GSA and makes the same recommendation in all jurisdictions. Langsam could not point to any specific use of Pacific data in arriving at his recommended return on equity.

Kroman for City of Los Angeles

Manuel Kroman, a consulting engineer in the field of public utility regulation, testified on rate of return for the City of Los Angeles. Most of his direct testimony consisted of a critique of Joses' and Litzenberger's methods, particularly those of Litzenberger's involving the present worth and pricing model methods. Kroman believes the methods have little value for use in a rate case because they depend so heavily on the input selected by the technician using them.

Kroman believes it is more reliable to look at comparable risk enterprises such as other telephone utilities. He broadens this field, although staying within the regulated sector, by giving consideration to the earnings of other utility groups such as electric and gas. Kroman, like others, stated that a primary consideration is to provide Pacific with the opportunity to earn at a level which will permit it to maintain its A bond ratings. He stated an additional guide to the general level of an appropriate rate of return is provided by the returns most recently authorized by other state regulatory commissions particularly for the telephone operations of General Telephone and the Bell System.

Kroman offered an exhibit showing returns authorized by state regulatory commissions employing original cost rate base for telephone subsidiaries of General. The median rate of return on equity for this group was 12%. The latest date for any decision in the group was for Florida, December 7, 1979, and ranged back to as early as August 1975. Kroman also offered rates of return authorized by state commissions employing original cost rate base for subsidiaries of the Bell System. The median for that group was 12.38% rate of return on equity, with many of the decisions dated in 1980, and showing a range of return from 11.03 in Montana to 14.50 in Utah. Kroman presented a table of return on equity and percent of equity in the capitalization of Pacific and 22 Bell System subsidiaries. For 1979 the 22, excluding Pacific, had a return on equity of 12.46% and an equity ratio of 58%. For Pacific the comparable figures were 8.60% and 40%. A similar table for 14 General subsidiaries showed a return of 13.56% on equity and an equity ratio of 42%.

Kroman accepts the staff's capitalization ratios and suggests an after tax interest coverage of about 2.2 times which is also the staff estimate. He believes if those ratios were adopted, the rate of return would be 11.81% with an allowance of 13.67% for common equity. Kroman believes an allowance for common equity in the range of 13.5 to 14% would be fair and reasonable.

Discussion of Rate of Return

We note that the latest debt security issues are selling for about 16%. Michigan Bell issued 40-year debentures which were sold April 28, 1981, priced to yield 15.93% at a cost to the company of 16.07%. Michigan Bell is rated AAA. Pacific Gas and Electric Company issued bonds in April at a cost of 16.35%.

Interest rates on Pacific's debt securities show increasing rates, the 40-year debentures sold June 28, 1979 at a cost to Pacific of 9.85%. A split issue of notes and debentures in February 1980 carried a cost to Pacific of 15.32% and 15.71%, respectively. Pacific's March 25, 1981 split issues sold at effective rates of 15.26% for the 10-year notes, and 16.44% for the 40-year debentures. AT&T paid 15.34% on an issue of $150 million of 40-year debentures on April 20, 1981. We note also that the FCC in its order May 11, 1981 granted AT&T an overall return of 12.75% with return on common and preferred stock set at 17.4%.

We will not go into a long critique on the various methods for determining rate of return on equity which have been presented to us; it would serve no useful purpose. We recognize the two general types of procedures used by the parties in this proceeding, first, the traditional judgment approach based on an extensive background of information available to the analyst and, second, the formula-type approach which requires the same kinds of background material and judgment for the appropriate inputs to the formulas used. We find in this proceeding an extensive amount of information has been put before us, all of it valuable. However, we cannot adopt strict mathematical formulas or models which usually depend on subjective inputs. On the other hand, we urge the parties and our staff, in particular, to consider in the future the possibilities of presenting for our information results from formula or model-type determinations in addition to the judgment calls they have given us in the past.

There are many charges and countercharges running through this proceeding which aim to place the blame for Pacific's present poor financial condition. Only one charge deserves comment. We view the action of AT&T not to purchase common stock shares of Pacific from 1973 to 1980 as the major contributing factor to the poor financial condition of Pacific today. The effect of that may not be measurable but we believe it had to have a significant detrimental effect as evidenced by Pacific's poor debt/equity ratio.

The result of this conscious decision by AT&T as far as the Commission in concerned is to place us in the position of now having to decide what we can do to help remedy a situation which, if allowed to continue, will result in serious detriment to the telephone consumers of California. Were we to close our eyes to the economic reality of Pacific's problems and apply normal or ordinary ratemaking principles to Pacific at this time, several things would undoubtedly occur in sequence. First, Pacific's credit rating would be downgraded by the two major rating agencies; second, the resulting cost of debt, to the extent it was available, would increase, leading to higher overall costs to Pacific's ratepayers; third, AT&T would have further reason to decline equity investment in Pacific, resulting in a prospective deterioration of Pacific's capital structure if we continued to authorize debt issues or, if we declined to do so, resulting in Pacific's inability to finance its necessary construction budget. Clearly the foregoing is not a bad dream; it has been amply supported in our evidentiary record as likely to occur if some extraordinary action is not forthcoming.

As a regulatory body we are capable of taking some steps to help alleviate Pacific's economic problems. We cannot, however, and will not attempt to solve that problem entirely on our own and at the ratepayers' expense. The regulatory process is one which requires cooperation, trust and good faith on the part of those who participate therein. Without the active participation of Pacific and its parent, the process fails and nothing the regulatory body does will allow it to survive. We have goals in mind for Pacific that we believe are achievable given a spirit of cooperation backed by concrete action. The chief goal is a massive infusion of equity capital aimed at achieving a fifty percent debt-fifty percent equity ratio in a time frame of 18 months with preferred stock included as equity. We think action by AT&T to restore that capital structure will lead to the realization of our second goal, which is an upgrading for Pacific's debt offerings. We think both of these goals can be promoted by action aimed at attaining our third goal, which is an increase in Pacific's common stock dividend coupled with AT&T reinvesting in Pacific the proceeds attributable to the higher dividend.

The very high return on equity recommendations made by Pacific's witnesses in this proceeding have no relation to the returns authorized for any regulated utility comparable to Pacific. Granting such a return on equity, e.g., 19.7 percent, would no doubt promote the perception of the regulatory climate in California but it also might be subject to reversal when tested against traditional ratemaking standards of reasonableness. It would not constitute a balance of the ratepayers' interests with those of the investor. (See City and County of San Francisco v. Public Utilities Commission (1971) 6 Cal. 3d 119, 129). AT&T, however, has recently been granted a rate of return, and a return on equity by the Federal Communications Commission which, while uniquely high by traditional standards, does present something concrete for us to consider as a measuring stick. The 17.4 percent equity return authorized AT&T's

Long Lines operations by the FCC constitutes what that body believes is required to attract capital to AT&T, a triple A rated company and one that has had no difficulty in issuing either debt or equity even in these difficult money markets. The 17.4 percent return constitutes a cap above which no investor in AT&T can reasonably expect to earn. Although Pacific is only a single A rated company, it does not face the competition which AT&T's Long Lines does, nor is its business as subject to cyclical variations due to expansion and contraction of the national economy. Pacific's return on equity therefore does not need to be set at a level higher than AT&T's.

With all the foregoing discussion in mind we find that due to the unique and difficult economic conditions which confront Pacific at this time, a return on equity of 17.4 percent and an overall rate of return of 12.91 percent is necessary to attract capital and to provide a reasonable expectation of achieving the goals for Pacific we have set forth above.

Were we dealing with Pacific in a less volatile and **difficult economic setting and with a balanced capital structure,** the return on equity and overall rate of return we would find appropriate would be considerably less than here authorized. We stress that both the external economic situation which affects all utilities as well as the internal problems that are unique to Pacific have combined in such a fashion as to require special action on our part. Although we know AT&T profits considerably from its operating companies in ways other than dividend payouts, we conclude this rate of return is nevertheless required in order to bring the capital structure back into balance. Our decision on this issue, however, should not be misconstrued. We expect that our having granted Pacific a 17.4 percent return on equity will remove any obstacle, real or illusory, to the massive equity investment we desire by AT&T or private investors.

After all, this authorized return is not only the highest granted any of the Bell operating companies, it matches precisely the return AT&T itself is authorized. AT&T therefore may maximize earnings for its shareholders by investment in Pacific the result of which should be a substantial improvement in Pacific's capital structure. We believe that within eighteen months from the date of this order Pacific should be able to balance its capital structure. Further, with the improved earnings prospect this decision grants Pacific we expect an increase in Pacific's dividend and a reevaluation of its dividend policy so that the minority shareholders and the market generally will be attracted to Pacific's equity. Increased AT&T equity infusion and an increased dividend will insure that private investors will find **Pacific's stock attractive.** In other words, there should be no reason why the capital structure cannot be balanced. AT&T's large equity investment in Pacific, including reinvested dividends, coupled with a Pacific dividend increase, should result in a much improved market price for Pacific's stock. This will resolve any objections that increased equity offerings **at a depressed market price will only dilute present owners' interests.**

As indicated earlier we are not only incapable but unwilling to solve Pacific's financial problems solely at the expense of Pacific's ratepayers. Hence Pacific is hereby put on notice that our rate of return and return on equity decision made today, while compelled by the evidence of record in this proceeding will be reexamined when we decide Pacific's next general rate case. We will look carefully to determine whether the goals and expectations we have here set forth are in the process of being achieved. If they are not, we will have to determine at that time, in light of the circumstances then prevalent, what the appropriate returns should be. In order to insure that our concerns are taken seriously and that we can evaluate capital offerings which come before us for authorization, we instruct Pacific to provide us within 60 days of this decision a financing plan indicating proposed capital offerings specifying approximate dates and amounts of such offerings for the two-year period after the date of filing (October 1981 - October 1983).

We will adopt the capitalization ratios of the staff together with the cost of long-term debt and preferred stock. These are shown on Table 29. The details of rate of return are shown on Table 34.

Increased Revenue Requirement

Subtracting the 9.19% return shown on Table 25 for the adopted intrastate results from the rate of return adopted of 12.91% produces 3.72%. 3.72% times the adopted rate base of $8,650,000,000 produces a net revenue requirement of $321,800,000. $321,800,000 times the staff net-to-gross multiplier of 1.896 produces an additional gross revenue requirement of $610,100,000. Equated to the $4,694,500,000 revenue under present rates results in an overall increase of 13.0%. It is noted that if we had not increased the rate of return over the 10.25% granted in D.91495, the gross revenue requirement would be $173,800,000.

TABLE 34

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Adopted Rate of Return
Test Year 1981

| Component | Ratio | Cost | Weighted Cost | Times Interest Coverage |
|---|---|---|---|---|
| Long-Term Debt | 53.29% | 9.87% | 5.26% | |
| Preferred Stock | 5.17 | 8.08 | .42 | |
| Common Equity | 41.54 | 17.40 | 7.23 | |
| Total | 100.00 | | 12.91 | 2.45 |

Service Considerations

Hearings for statements and testimony from the general public were held throughout California. These sessions were generally in the afternoon and evening to give the public a good chance to participate. The sessions were held in San Francisco, Los Angeles, San Diego, Sacramento, Eureka, San Luis Obispo, and Fresno. Most were well-attended; the one in Los Angeles was held on a Saturday. Of the complaints received from the public, Pacific investigated each one and reported back to the ALJ during the later hearings in this case. As of the close of hearings in April, only a few were still outstanding; those are being concluded as rapidly as possible.

Outside of the individual consumers noted above and some of the telephone answering services, most notably one in Stockton, the more serious service complaints came from WBFA and concerned the repair and installation of private line services. WBFA contends Pacific has failed to provide adequate service for the installation and repair of private line services used by the alarm industry. WBFA witnesses presented evidence of this failure and it appears it has been a recurring and unsolved problem since 1975. Testimony shows the number of new installation orders that are not installed on assigned due dates have increased dramatically recently. Evidence reflects that less than one-half of the installation due dates are met and long delays are not uncommon. Art Nettles, a staff engineer and witness for the staff on quality of service, stated he did not prepare an independent study of the quality of service for private line circuits. He did, however, make a limited telephone survey of the large metropolitan areas in California on burglar and fire alarm companies and telephone answering services. He contacted 30 burglar and fire alarm companies and his findings reflect that about 50% of the companies polled said their service was unsatisfactory. Nettles testified the main reason given was installation commitments not met. WBFA claims Pacific's performance in repairing alarm circuits has been steadily declining since the early 1970s. Because alarm circuits must be operational 24 hours per day in order to do the job they are designed for, Bell System practice requires that out-of-service conditions should be cleared within two hours. As a result of these problems, and in an attempt to improve the situation, WBFA recommends that a committee be formed with representation from the alarm industry, Pacific, and the staff. The committee would establish reasonable standards for the installation and repair of private line services used by the alarm industry and such standards could be incorporated into a Commission General Order. We will adopt the recommendation.

For his report on telephone service, Nettles used various telephone service quality indicators to evaluate the level of service provided by Pacific. These indicators are detailed in Commission General Order (GO) 133. Pacific's internal measurements were reviewed by Nettles to rate the following categories of service:

a. Held orders.
b. Installation commitments.
c. Customer trouble reports.
d. Answer consistency - toll and directory assistance.
e. Business Service Centers.
f. Residence Service Centers.
g. PhoneCenter Stores
h. Network services.

In addition to GO 133 and Pacific's internal indicators, the staff also reviewed customer opinions gathered by such systems as Telephone Service Attitude Measurement Plan (TELSAM) and customer complaints to evaluate customer perception of Pacific's service quality.

In D.90642 the Commission ordered Pacific to furnish reports and/or provide plans to improve its service performances in several areas. The staff took each of the ordering paragraphs and commented on the company responses. It appears all of these matters are being taken care of properly and will require no further action in this decision.

The staff concluded that Pacific's overall service performance level stabilized in 1979 and showed improvement in 1980. A substantial improvement in service performance in 1981 is expected because of increasing expenditures for growth and completion of projects which will provide additional system capacity. Table 35 summarizes the status of indicators used by the staff to evaluate the level of performance provided by Pacific. The staff concludes that in general Pacific has provided adequate service during a period of significant growth in telephones and telephone usage. The staff further concludes that network services in southern California and overall service in the Los Angeles sector have deteriorated over the years and currently are at less than desirable levels. The existing problems are slowly being resolved by programs, increased work force, and adherence to construction schedules. Other than the problems with private line services discussed previously, second quarter trends in 1980 indicate headway is being made in improving the service performance.

TABLE 35

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Service Measure Trends

| Service Measure | Performance Trend Relative to Preceding Year 1979 | 1980 | 1981 (expected) | Remarks |
|---|---|---|---|---|
| Held Orders | | | | |
| Primary | + | + | NC | Adequate |
| Regrade | + | + | + | Adequate |
| Installation Commitments | + | + | + | Adequate (Performance adequate, but deteriorating in LA Sector.) |
| Customer Trouble Reports | NC | NC | NC | Performance improving in LA Sector. Pacific to continue complying with Ordering Para. 13.b, D.90642. |
| Answer consistency - Toll and Directory Asst. | + | + | + | Adequate |
| Business Service Center | + | + | + | Adequate |
| Residence Service Center | + | + | + | Adequate |
| PhoneCenter Store | * | + | + | Adequate |
| Network Service | - | + | + | Network performance is improving but below desirable level. |

Plus - Improving performance trend.

Minus - Declining performance trend.

NC - No significant change in performance trend.

* - No service measures in 1978.

Considerations Affecting
Rate Design

A long time ago in a faraway place the FCC issued the Carterfone decision.[11] Until that decision the Bell System and the so-called independent telephone companies operated as complete monopolie in the telephone industry providing local service and nationwide toll service through networks interconnecting the Bell System OTCS and the independents. Carterfone allowed telephone terminal equipment owned by phone company customers to be connected to the phone system, signaling the start of modern telecommunications competition. By 1978, companies such as Microwave Communications, Inc. (MCI) were able, because of court decisions, to provide message toll service in direct competition with the Bell and independents' systems. Then in 1980 came the FCC Computer Inquiry II decision ordering deregulation of telephone terminal equipment[12] by March 1, 1982 and, further, ordering AT&T and GTE to form fully separated terminal equipment subsidiaries to handle the deregulated activities. As noted in the section on affiliated relationships this puts Pacific in a transition period requiring extraordinary regulatory oversight by the FCC and commissions such as ours to ensure that customers of the remaining regulated portions of the phone systems are treated fairly during and after the transition, the assumption being that competition will take care of the unregulated operations. Costs associated with the establishment of the fully separated operations must be borne by those operations, and terminal equipment investment and associated tax and depreciation reserves left with the still-regulated portions should reflect accurately the remaining physical plant necessary to serve the regulated sector, on which, of course, revenues to recover the investment with a return will be required.

11/ Carterfone v AT&T (1968) 13 FCC 20420, Recon. Den. 14 FCC 20571.

12/ FCC Docket 20828 (1980), 80-628.

We have addressed the costs associated with the establishment of the unregulated activities for purposes of this decision in the section on expenses. We turn now to the problem of terminal equipment which will remain with Pacific after March 1, 1982, the most bitterly contested issue in this proceeding. Three sub-issues are involved:

1. The AT&T/Pacific "installed base migration strategy," (migration strategy).
2. Developing equipment costs for ratemaking.
3. If large increases in terminal equipment rates are required, how they should be phased in.

Migration Strategy - Positions

Based on exhibits of record, the migration strategy can be described as a product-pricing strategy for the Bell System which has the following goals:

1. Improve product line contribution.
2. Price position the product line, that is, establish flagship[13] product prices and reprice older products.
3. Migrate (move) present customers to flagship products.
4. Prepare customers for the next generation of products.
5. Position the Bell System as the market leader in the emerging competitive telecommunications/ information systems market.

No other issue in the proceeding was contested as vigorously as this one. The Users Group led the charge, closely followed by CEMA, Sonitrol, TASC, and WBFA. Users Group reviewed thousands of Bell System documents through the discovery process, called several adverse witnesses, and made their own affirmative presentation through three witnesses.

The Users Group believes the migration strategy is a firmly entrenched AT&T/Pacific policy, that is inimical to the public interest, encourages unnecessary customer movement, and is an inefficient and

13/ Flagship products are the newest top-of-the-line offerings representing Bell System's version of the most advanced state of the art.

wasteful use of resources. To support its charges, the Users Group points to the following from Exhibit 272 sponsored by Jennifer Taylor, a consultant for the Users Group:

1. In AT&T's own terms the migration strategy is planned to accelerate the movement of terminal equipment customers from older generation products to Bell System's newer generation equipment.

2. There is a concerted effort to upwardly reprice older equipment in relation to newer equipment so existing customers will migrate from old equipment to newer equipment under contract thereby enabling the Bell System to retain its dominant position in the market and keep present customers "in the fold" during this critical competitive period. This would also position the Bell System to move these same customers to yet another series of newer Bell equipment by the mid-1980s.

3. An "incremental willingness to pay" analysis was undertaken by AT&T which had the intended effect of increasing rates for older equipment to a point where customers would find newer equipment more attractive. The analysis determined what price differential would encourage 80% of existing customers to migrate from older to newer equipment.

4. In 1979 and 1980, AT&T sent numerous documents concerning the migration strategy to the OTCs including Pacific. For example:

   a. Regulatory Support Binder.

   b. Migration Strategy Master Plan.

   c. Dimension PBX Vintage Pricing Strategy - Regulatory Rationale.

   d. Centrex Migration Strategy Recommendation Letter.

   e. AT&T Target Pricing Support Package.

   f. AT&T Migration Strategy Recommendation Letter.

Users Group claims AT&T directed the OTCs to engage in aggressive marketing programs to secure the embedded market against competition. These programs included substantial additions of personnel, new training programs, and incentive compensation programs. The substantial costs of such programs will be recovered as short-term expenses from existing ratepayers of regulated services even though the expected benefits will be realized mainly subsequent to deregulation of terminal equipment in March 1982.

Because of the current competitive environment, Users Group believes the majority of customers who are induced to migrate will have little choice but to take service from Pacific. Even though Pacific retains the customers, substantial amounts of useful and functional equipment will be retired to the junkyard. Its undepreciated investment will be stranded in the rate base to be paid off by future ratepayers. Users Group sees the migration strategy, therefore, as promoting wasteful churn and abandonment of useful assets which is contrary to the public interest because it requires additional investment in areas which do nothing to improve national productivity. Users Group points out that the so-called stranded investment occurs because of the accounting treatment used for group remaining life depreciation. When an item of plant is retired, any undepreciated portion remains in rate base because the plant investment amount retired is also the amount removed from depreciation reserve. Thus, if an item with a historical cost of $100 and $80 accrued depreciation is retired, the depreciation reserve account is reduced by $100, $20 too much. Eventually, the stranded $20 must be recovered; the only way that can be done is through rates paid for other equipment or services.

Although many of the concerns of the Users Group are based on Bell System documents and actions, Users Group believes Pacific is firmly committed to the migration strategy. Again from Exhibit 272, Pacific's documents indicate Pacific's management recommended "a concerted effort to churn the base of older electromechanical PBX vehicles to zero by 1982," an even more ambitious plan than AT&T's 80%. In October 1979 Pacific submitted a detailed migration plan to AT&T including data on inventories, customer movement, rate plans, and financial impact analyses under a "business as usual" plan and a more aggressive marketing plan.

One may ask, if the equipment is turned over prior to March 1, 1982 and Computer Inquiry II applies only to terminal equipment installed after March 1, 1982, how the unregulated operations could take or leave any investments or reserves that could adversely affect the remaining regulated entity. The answer, claims Users Group, is twofold.

First, in the case of equipment replaced prior to March 1, 1982, all the stranded investment is left in the rate base of the regulated entity even though the investment and revenue earning capability of its replacement is also left. In the case of equipment left with the regulated entity and replaced after March 1, 1982, the replacement will go to the unregulated operation and the investment and reserve of the equipment replaced will be on the books of the regulated company, together with any losses associated with stranded investment or profits from overdepreciation. With the migration strategy, Users Group claims losses will be the most likely occurrence.

Second, the investment and revenues for terminal equipment installed after March 1, 1982 will not be a part of the regulated operation. However, present Pacific ratepayers are paying for research and development, training, and sales efforts connected with that equipment. Users Group claims that given the time required to change over a large business system from old to new equipment, almost all sales made in 1981 will be cut over to the new deregulated operations in 1982.

Users Group's fundamental concern as put in its brief is that "Pacific should not be permitted to adopt pricing or marketing practices, the purpose of which is to accomplish post-deregulation market positioning, if such practices result in unwarranted rate increases for customers of installed base equipment, or create a residue of stranded investment to be recouped from regulated ratepayers."

Pacific denies it had any marketing objective to force customers against their wishes out of its older equipment. It claims its marketing objectives are very simple: (1) to assure that rates for older terminal equipment cover costs, and (2) be in a position to offer more technologically advanced and cost-effective terminal equipment services to customers who have need for such services.

Pacific asserts that the idea that it manipulates its rate proposals to foster the migration strategy is fallacious. It points out that about 3 of every 4 California customers who acquire new PBX systems get them from competitors of Pacific, and therefore, if Pacific aggressively went after its customers to replace equipment and the customers did, it would lose 75% of those customers. Pacific points to testimony of its witnesses that the proposed rates for older terminal equipment are pegged as precisely as possible on costs developed by Pacific's equipment costing procedures, and that rates for flagship equipment are 17 to 44 percent above costs.

Pacific contends that its pricing objectives are not designed to drive customers out of older equipment into flagship equipment but are designed to improve the revenue/cost relationship for the terminal equipment. Pacific points to Exhibit 118 as support for this contention. Exhibit 118 shows that rates proposed by Pacific in this case will produce revenue/cost ratios for older PBX and key telephone services very close to 1.00. Thus, the general body of ratepayers will be better off because they will not have to subsidize terminal services as they do now.

Migration Strategy Discussion

Witness Brown for Pacific (Tr. 4214) stated Pacific embraced the migration strategy but not its pricing concepts. Yet, proposed rates based on Pacific's cost studies show some older equipment would be priced substantially above flagship equipment.14/

14/ The background and nature of these studies will be discussed shortly.

For example, a sample of 4 system sizes shows older 701 PBX equipment was priced an average of $473 or 17% below the new Dimension equipment on April 1, 1980, at rates prior to the April interim increase; under rates proposed in A.59849, this proceeding, the same older equipment would be $459 or 15% above Dimension equipment. This information is from Exhibit 270 of Users Group witness Free.

Pacific's own estimates of its market share and projected systems in service, 1979-82, indicate Pacific's intent under the migration strategy. Table 36 was extracted from Taylor's Exhibit 272 by witness Selwyn of Users Group and summarized in Exhibit 273. The basic data on Table 36 are contained in a 1980 migration plan report by Pacific to AT&T. The table shows that Pacific's objective over a 3-year period was to cut its old technology equipment almost in half and more than double flagship equipment while still maintaining a 69% share of the market against its competition. The portion of old technology PBX would drop from 64% to 30%. Considering that terminal equipment has a useful life of about 10 to 20 years the objectives seem rather severe.

TABLE 36

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Projected Systems in Service
1979 - 1982

Market Share

| Year | PT&T Old Technology | PT&T CO | PT&T Flagship | Competition | PT&T Market Share | Competition Market Share |
|---|---|---|---|---|---|---|
| 1979 | 11,172 | 753 | 6,267 | 4,824 | 79% | 21% |
| 1980 | 10,011 | 777 | 7,884 | 6,027 | 76% | 24% |
| 1981 | 8,191 | 799 | 10,647 | 7,385 | 73% | 27% |
| 1982 | 5,906 | 810 | 13,892 | 9,294 | 69% | 31% |

**Percent Old Technology**

| Year | Old PBX | Key | Flagship | Total Systems In Service | Percent Old Technology |
|---|---|---|---|---|---|
| 1979 | 5,776 | 5,396 | 6,267 | 17,439 | 64% |
| 1980 | 4,611 | 5,400 | 7,884 | 17,895 | 56% |
| 1981 | 3,191 | 5,000 | 10,647 | 18,838 | 44% |
| 1982 | 1,506 | 4,400 | 13,892 | 19,798 | 30% |

There seems to be no doubt that Pacific did indeed embrace and pursue the goals of the Bell System migration strategy. The evidence is too pervasive to believe otherwise. A parade of documents shows plans, objectives, quotas, incentives, and so forth, all designed to accomplish the installation of flagship equipment, whether or not it replaced old equipment. Brown testified that the AT&T migration information proved valuable to Pacific because it focused Pacific's attention on customers who had unmet needs for more sophisticated terminal equipment although it was not Pacific's policy to force customers out of older terminal equipment. We fail to see how one can sell new equipment to a present customer without causing that customer to give up present equipment unless it is merely an expansion which, as we view this record and Pacific's objectives, is not the average situation. The charge of whether Pacific took, or wishes to take in this case, the final step of pricing old equipment out of the market is not clearly proved by this record. That question somewhat hinges on whether Pacific found its up-to-now-valid method of costing equipment fostered the objective and therefore did not have to take overt action. Pacific's witnesses deny that charge and we find no evidence to the contrary. We move now to a dicussion of those costing procedures.

<u>Costs for Ratemaking</u>

The main method used by Pacific and the staff for developing equipment costs upon which rates can be based is the GE-100 procedure. The method has been used for over 30 years. The procedures and assumptions employed are continually reviewed and have been revised many times. The procedure develops costs for four major factors:

1. Depreciation of material and installation costs.
2. Maintenance and other direct support costs.
3. Overheads.
4. Return on investment and allowance for income taxes.

Several parties to the proceeding attacked the GE-100 procedure as well as other costing procedures for such offerings as private line services. Again, the Users Group led the opposition, calling as a witness Lee L. Selwyn, president of Economics and Technology, a consulting firm specializing in telecommunications economics, regulation, and policy. Selwyn took on the GE-100 process with vigor. Also attacking the costing procedures were witnesses Krause for CHMA, Edwards for Sonitrol, Weiss for TASC, Blakesley for Delphi, and King for WBFA. Only the staff supported the GE-100 studies and even that support became a little shakey as hearings progressed. We will not detail the charges and countercharges about costing methods. The record shows, despite Pacific's protestations, that serious shortcomings in costing procedures are evident. We can put the situation no better than the staff, an early supporter, did in its brief which we paraphrase and/or condense in the following three paragraphs.

In this proceeding rates have been proposed by Pacific and the staff that are at or above the GE-100 level. These rates result in substantial increases for some services such as equipment used by the telephone answering services. Old technology equipment such as PBXs and KTS would also be increased substantially, which Pacific now concedes agrees with AT&T competitive migration strategy pricing. Accordingly, the GE-100 process was subjected to substantial scrutiny in this proceeding. Users of private line services also were extremely concerned because of substantial price increases as well as indications that competitive services are soon to be offered by the Bell System. The substantial price increases also affect equipment used by the hotel/motel industry.

The record abundantly demonstrates that all of the foregoing user interests proved substantial weaknesses in the cost factors used by Pacific in its GE-100 methodology. The preponderance of evidence became so overwhelming on this point that the ALJ, late in the proceeding, finally had to call a special conference to discuss what could be done at that late point to rerun the GE-100 cost sheets using more realistic cost factors.

On April 15, 1981 Pacific Counsel White submitted the results of the reruns which were made with variations requested by the ALJ and the parties in connection with Exhibit 339. This letter was superseded by a letter dated April 27, 1981 which transmitted revisions and reruns of the April 15 transmittal. White indicated that the reruns showed wide variations. He concluded by requesting that any refinements to be made in the GE-100 methodology should be undertaken only after more analysis than what had been possible in the limited reruns described above. He concluded by saying "at that time further regulatory accounting changes can be considered for inclusion in both the GE-100 and category studies." It is clear that all parties, even Pacific, concede further refinements of the GE-100 methodology are necessary to reach reasonably acceptable costs by that process. The staff suggests that should the Commission conclude present costing techniques are inappropriate for setting rates in this proceeding, any increase should be by a uniform percentage thus keeping all rates relatively the same. There could be some exceptions to that such as the 60¢ charge for station sets which indisputably does not cover costs.

Intermediate Actions for the Transition Period

In summary, we see four intermediate actions which must be taken during this transition period.

1. Review and determine equitable costing procedures.
2. Determine and allocate to the proper user any net stranded investment.
3. Determine the costs, both capital and expense, of establishing the nonregulated operations.
4. Establish tariffs for the sale of terminal equipment.

We will order further hearings to resolve the costing procedures to be adopted for making rates for now and the near future.

To make sure that the responsibility for any stranded investment is properly borne by the class of user responsible for it, or in the alternative the stockholders, we will order Pacific and the staff to expeditiously determine the kinds, if any, of equipment that have been retired prior to being fully depreciated, **the associated amount of undepreciated, or stranded, investment, and a method for** fairly recovering any stranded investment. These studies can be presented during the further hearings we will hold.

**On the point that customers paying rates to the** regulated company now and after March 1, 1982 should not bear any expenses associated with the formation or operation of the unregulated company, we have adopted some staff proposals in this proceeding. We recognize these are estimates at this time. However, in its second order and decision in Docket 20828, supra, released December 30, 1980 the FCC at paragraph 105 required AT&T to:

1. Account for all expenses incurred to date relating to existing and future enhanced service offerings.
2. Account for all expenses incurred to date that directly relate to the future subsidiary.
3. Submit a plan for describing an accounting procedure for the interim expenses relating to the provision of enhanced services.

The purpose of the foregoing is to provide a mechanism to control and to hold AT&T accountable for the expenses incurred in the interim period before deregulation while it is setting up the subsidiary. It is reasonable for this Commission to order PT&T to provide a similar accounting of the expenses incurred in establishing unregulated operations in California.

Pending conclusion of further hearings, we will hold Pacific's management fully accountable for protecting the interests of the ratepayers in the creation of the subsidiary. We are inclined to treat all further expenses allocated to the new entity as a loan from Pacific drawing interest at the prime rate, but will be receptive to other proposals at the hearings. The payment of such a loan could be treated as an offset against rates in a future year, thereby producing a rate reduction upon repayment. Pacific's management should take whatever steps necessary during the creation of the new entity to assure the timely repayment of start-up expenses.

Sale of Equipment

The record convinces us there is a need to examine terminal equipment pricing. As we discussed under Costs for Ratemaking the traditional method for determining rental rates for terminal equipment is flawed; but, more fundamentally, the continued rental of telephone terminal equipment may not be the best policy as we approach deregulation of that equipment. It appears that offering terminal equipment for sale at net book value is a more fair and reasonable arrangement for utility and user.

Deregulation in the form of separate operations for provision of terminal equipment aside, sale of terminal equipment appears to be desirable. Terminal equipment is becoming increasingly mobile because of modular jacks and compact equipment, and it may be more desirable for customers to own the equipment instead of the utility. Substantial billing and tracking expenses are involved with utility ownership, and equipment is easily stolen, both of which add to consumer costs. With customer ownership,handling and billing costs will be reduced substantially, and theft is not a problem.

Sale of terminal equipment will also lead to greater customer understanding and choice of products. For design line phones, Pacific's current tariffs give the illusion that the product is sold, when actually, the customer buys the shell and not the functional part of the phone. By selling the phone and separating maintenance, customers could even have a choice of who maintains the phone. Currently, maintenance is buried in the rental charge, and customers are not aware of its cost or the cost of insurance against theft.

Pacific itself could benefit from the sale of terminal equipment. There would be a substantial cash infusion which would greatly assist Pacific in meeting its capital program.

Our desire to implement sale of terminal equipment is also substantially motivated by pending proposals to deregulate the terminal equipment market.

Both the FCC Computer Inquiry II decision and proposed Federal legislation (S.898) provide for the formation of a fully separate deregulated AT&T subsidiary for terminal equipment. Under the FCC order, the subsidiary will be formed next March. The unresolved question is how existing rented, tariffed Bell System terminal equipment should be handled once the subsidiary is formed. The current FCC plan provides for embedded equipment to be rented by the regulated operating companies. Because of all of the problems with separating operations between new and existing equipment, the Bell System has proposed to transfer all existing equipment to its new subsidiary. While perhaps reducing the waste, confusion, and inconvenience of the FCC's plan, AT&T's approach creates a more critical problem. The deregulated subsidiary would have a dominant market position to charge excessive prices because it would own the vast proportion of terminal equipment available. That result greatly concerns us. With the sale of terminal equipment under tariff, customers would have the opportunity to purchase that equipment at a reasonable price before it is transferred to the unregulated Bell subsidiary.

The opportunity to purchase terminal equipment is also the perfect answer to the migration strategy, saving ratepayers from the twin evils of higher rental rates and increased stranded investment.

While we are pursuaded conceptually that sale of terminal equipment is desirable, there is not sufficient evidence in this record to develop an appropriate order establishing tariffs now. Also because of the issues we will take over to further hearings such as equipment costing, stranded investment, and depreciation rates, and because all interested parties have not had a chance to fully respond to the proposals in this proceeding for sale of equipment, we will take this issue also to the further hearings.

We think it critical that the public as well as the parties to this proceeding understand that we view sale as a highly desirable course for the future and one that, barring unforeseen obstacles, we will move quickly to implement. We will expect all telephone companies, the staff, and any interested parties (respondents to OII 81) to file proposals by September 15, 1981 for sale of equipment for cash or on terms as well as its continued maintenance. Such proposals should anticipate that book value will be the appropriate starting point for determining a fair price.

Phasing In Rate Increases

As far back as 1913 the Commission had in mind that rates for each telephone service should cover the cost of that service. In D.1082 (1913) 3 CRC 903 the Commission said:

> "...we know of no reason why the toll and exchange business should not be kept separately and each class of service bear its just proportion of supporting the institution."

We have not changed that philosophy and find it even more apropos today with emerging competitive conditions. In this proceeding both Pacific and the staff testified that that is their ultimate aim, to have all services and equipment bear rates reflecting their fair share of costs. Even though there are and have been exceptions to the principle, we have repeatedly warned that we intend to set rates commensurate with costs. This proceeding is no exception but we are not satisfied with the costing procedures. Until this can be taken care of to our satisfaction by further hearings we will hold increases in terminal equipment to a minimum.

We serve notice, however, on all classes of service and users of equipment that we intend to continue to move to cost-based rates. We will do this in a phased manner by reverting to our previous policy of no increases greater than about 50% per year for any class of service or equipment.

Also, the increase we will grant on an interim basis pending final allocation to customer classes will not be subject to refund. We will do this so Pacific and the financial community will be sure of the revenue flow for 1981-82.

Rate Design - Introduction

The principal rate design concerns of most of the parties were the private line and terminal equipment rates which relate to the cost studies we are referring to further hearings. The non-Bell independents were concerned mostly with toll rates. Most of the testimony on specific rate design was presented by Pacific and the staff. They did not disagree on the broad principles of rate design, but had some differences on minor issues related to emphasis in one area or another. The main difference between Pacific and the staff on specific rates recommended was due to the wide difference in total revenue requirement resulting from their estimated results of operations. In some instances we have adopted Pacific's proposal, in some the staff proposal, and in others a compromise. We have attempted to adopt what we consider the best features of all proposals for those rate increases we will authorize. As previously discussed we will not increase private line and terminal equipment rates (except for station sets) beyond a small amount to balance the required revenue increase. The specific rates we are authorizing by this decision are contained in Appendix F.

Our first objective in rate design is to develop a spread of rates which will meet the revenue requirement found appropriate in this proceeding. Our second objective is to provide a fair distribution of any rate increases among customers and classes of service consistent with any necessary restraints such as holding to a minimum increases for those services which will be subject to additional consideration in further hearings.

For operations as complex as Pacific's a simple percentage increase in rates applied to all customers is not adequate. In determining particular rates we must consider factors such as cost of service, rate history, rate relationships, proposals of the parties, elasticity of demand and related revenue repression, settlements with connecting companies, and general effects on customers. For instance, in assessing the effects of a rate structure on customers we must consider total customer billing by class, the portion of a customer's bill affected by a particular rate change, whether the service is essential or discretionary, what options to the service are available, and the benefits of the service.

To meet the revenue requirements which we find to be appropriate, total revenue must be increased by $610.1 million. Based on the record and the above factors we will adopt rate changes which result in the distribution of the $610.1 million as set forth on Table 37.

It will be noted on Table 37 that the sum of the items for which we have provided specific rates totals $550.7 million. The difference of $59.4 million to make up the total revenue requirement represents a residual amount to be recovered by a uniform surcharge on the services and equipment not otherwise increased by this decision. We believe it is fair that all customers and services somehow share in a rate increase of this magnitude even though we have yet to resolve some of the costing and rate problems associated with private line and terminal equipment.

TABLE 37

PACIFIC TELEPHONE AND TELEGRAPH COMPANY
Revenue Distribution of Authorized Rate Revisions
(Dollars in Millions)

| Item | Annual Revenue Increase | Percent Increase |
|---|---|---|
| Basic Exchange Access Rates: | | |
| Residence Service | $ 66.8 | 16.3 % |
| Business Service | 67.1 | 37.5 |
| Semipublic Coin Service | 5.1 | 6.2 |
| Zone Usage Measurement Service | 19.2 | 8.2 |
| Foreign Exchange Service | 7.3 | 9.2 |
| Multi-Element Service Charges | 31.5 | 36.0 |
| Station Sets | 37.6 | 16.0 |
| Message Toll Telephone Service | 228.8 | 12.7 |
| Wide Area Telephone Service | 21.1 | 14.1 |
| Optional Residence Telephone Service | 8.2 | 17.9 |
| Optional Calling Measured Service | .4 | 22.2 |
| Elimination of Proposition 13 Discount | 76.7 | - |
| Rate Adjustments: | | |
| Residence Modular Conversion Program | (9.6) | - |
| Business Interior Wiring | (8.8) | - |
| Expansion of SMRT | (0.7) | - |
| Subtotal | $550.7 | - |
| Surcharge on Unrevised Services | 59.4 | 5.4 |
| Total | 610.1 | 13.0 |

(Red Figure)

Basic Exchange Access Rates

Residence exchange access rates will be increased by $66.8 million. The detail of the rates is shown on Table 38. This is more than the amount recommended by the staff, and less than half that recommended by Pacific. Increases to residence service have been placed entirely on the individual line flat rate residence service. We make no changes to either the measured rate services available in the metropolitan areas or to the party-line services available in areas where measured rate service is not available. The authorized rate for residence individual line service of $6.70, or $7.00 in ZUM areas, cannot be considered excessive at today's price levels; however, there may be some customers priced out of the market. Because some customers may want to adjust their telephone service to meet budget restrictions we will provide for an exemption from Pacific's usual change-of-service charges for individual line flat-rate service customers who wish to change to measured rate or party-line service. We note that in previous proceedings we found that many flat-rate service customers benefit by changing to measured rate service. In accordance with findings in earlier decisions we consider measured rate service to represent the fairest distribution of cost among customers and to be the ultimate principal service for residence customers.

TABLE 38

PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Present, Proposed, and Authorized
Basic Exchange Rates#

| Service | Present | Proposed Pacific | Proposed Staff | Authorized |
|---|---|---|---|---|
| **Business Service** | | | | |
| 1-Party Measured (SF-EB & LA) | $7.00(4.00)* | $9.00(2.00)* | $5.00(0) | $7.00(0) |
| 1-Party Measured (Other) | 7.00(80) | 9.00(40) | 5.00(0) | 7.00(0) |
| PBX Trunk Measured | 3.50(0) | 7.00(0) | 5.00(0) | 7.00(0) |
| Semipublic Coin | 6.80 | 13.00 | | 13.00 |
| **Residence Service** | | | | |
| 1-Party Flat (SF-EB & LA) | 6.00 | 8.50 | 6.50 | 7.00 |
| 1-Party Flat (Other) | 5.70 | 8.20 | 6.20 | 6.70 |

* Message allowance stated in dollars.

\# Plus EAS increments, where applicable.

SF = San Francisco Metropolitan Area

EB = East Bay " "

LA = Los Angeles " "

While the business service increases are above the increase recommended by the staff, we adopt the staff recommendations as to structure. We are making no increases in the business flat-rate services which are available outside of the metropolitan areas. Within the metropolitan areas only nonoptional measured rate business service is available. Our final rate for these services is $7.00, with no message allowance. For the PBX trunk rate, we adopt the staff's rate structure principle of having the same rate applicable to business measured rate individual lines and PBX trunks. As pointed out by the staff, for some of the new types of equipment it is difficult to determine if it is a PBX or a key telephone system. Accordingly, a much simpler administration will result from application of a uniform access line charge. This is particularly true where customer-owned equipment is involved and Pacific does not have to distinguish between the two classes of access line. Also, the staff's recommendation for a zero message allowance will allow for charges to be made in accordance with originating usage. This will benefit many business customers who rely on the telephone principally for incoming service, e.g., order taking. On the other hand, customers with mainly outgoing service will pay an appropriate amount for the service they actually use.

On Table 37 it can be noted that business customers have been assigned a much larger percentage increase for basic service than residence customers. However, many of the terminal equipment and key system increases proposed for business customers are being postponed pending the further hearings on cost of service, and many business customers will experience lesser increases than they would have under Pacific's proposals. Further, we do not consider it appropriate to increase residence rates to make up for possible deferred increases on business terminal equipment. The ultimate disposition of these questions must await final determination of the cost-of-service matters.

The last area of basic exchange rates we discuss is semipublic service. As compared to public telephones, which are entirely the responsibility of Pacific, semipublic service is furnished to subscribers such as business establishments where there is a combination of subscriber and general public use of the service. Many small businesses rely entirely upon semipublic service as their principal service. We will adopt Pacific's proposed rate for this service. While there are no cost studies on this record regarding pay telephones, we are generally aware that a coin telephone is an expensive device compared with the ordinary telephone. In addition there are numerous costs associated with coin telephones, including extraordinary maintenance and coin collection, that are not applicable to ordinary instruments. Also there is no separate charge for the coin telephone instrument whereas with a business telephone the instrument charge is separate. Based on all of these factors we believe the rate proposed by Pacific of $13 per month is reasonable.

No changes were proposed by Pacific or the staff in party-line business or residence service or in measured residence (including lifeline) rates. Accordingly, we are authorizing no increases in such rates.

Zone Usage Measurement Rates

Neither Pacific nor the staff proposed any basic change in Zone Usage Measurement (ZUM) service except for the level of evening discount. The main difference between Pacific and the staff is the amount of revenue required. Pacific proposes to change the evening discount from 35% to 25% and the staff from 35% to 30%. Under the staff's proposal the discount schedule would be identical with that applied to intrastate message toll service. We believe that uniform discounts for toll and ZUM will be more understandable. We believe ZUM rates should be increased and will adopt the staff's proposal which provides for no increase in the Zone 1 (local rate). The initial minute rate for Zone 2 (9-12 miles) is increased from 6 to 7 units with no increase in the 3-unit rate for each overtime minute. The initial minute rate for Zone 3 (13-16 miles) is increased from 7 units to 8 units, and overtime minutes are increased from 4 units to 5 units. The price per unit is unchanged at 1 cent for basic service and 1.2 cents for foreign exchange service. No change is made in the night and weekend discount of 60%.

Foreign Exchange Service

Foreign exchange service (FEX) allows a customer in one exchange to be connected with a central office in another (foreign) exchange or district area. Under this plan the customer is considered to be in the local calling area of the foreign exchange for both incoming and outgoing calls. This service has been offered in California for many years and has helped to resolve many boundary problems where customers in one exchange may have a greater interest in a nearby exchange than they do in the principal communities of their own exchange. Because foreign exchange service is often used as a substitute for toll it has been suggested that it be offered on a measured basis only.

Ordering Paragraph 11a of D.90642 required Pacific to provide, as a part of its next major rate case, a proposal for offering all foreign exchange service on a fully measured basis. In compliance Pacific proposes, in this proceeding, to freeze the present offering of flat rate residence FEX service in exchanges where measured service is presently offered and to also freeze flat rate residence FEX service coincident with the introduction of measured residence services in areas where such services are not offered.

In addition to such a freeze Pacific also proposes to:

1. Increase the monthly recurring rates for one-party flat rate residence FEX service in both ZUM and non-ZUM exchanges by $2.50 per month.
2. Increase the monthly rate per quarter mile for mileage associated with one-party measured rate residence FEX service from $1.25 to $1.60.
3. Offer one-party business FEX lines and FEX PBX trunks at a common rate of $17.00 per month in all exchanges where such services are offered.
4. Remove the usage allowances on business FEX lines and trunks.
5. Freeze the present method of measurement and application of mileage rates associated with contiguous FEX services to existing services and provide that mileage rates for future contiguous FEX services will be measured and applied in the same manner as presently applied to noncontiguous FEX services.
6. Increase service connection charges applicable to the provision of FEX services.

The total revenue effect of Pacific's proposal is an increase of $10.5 million during the test year.

Ordering Paragraph 11a of D.90642 resulted from the Commission's adoption of the staff's recommendation to convert all flat rate FEX services to measured services. The staff therefore concurs in Pacific's recommendations. Since all business FEX service is either provided on a message or measured basis, Pacific's proposal to freeze flat rate residence FEX service will achieve the full intent of Ordering Paragraph 11a in a reasonable manner over a period of time without withdrawing any existing FEX service.

In addition to concurring in Pacific's recommendation to freeze the offering of one-party flat rate residence FEX service in exchanges where measured residence services are offered, the staff's proposed revisions for rates and charges applicable to FEX services include the following:

1. Increase the monthly recurring rates for one-party flat rate residence FEX service in both ZUM and non-ZUM exchanges by $1.10 per month.
2. Offer one-party business FEX lines and FEX PBX trunks at a common rate of $15.50 per month in all exchanges where such services are offered.
3. Remove the usage allowances on business FEX lines and trunks.
4. Increase service connection charges applicable to the provision of FEX services.

It is estimated that adoption of the staff's proposal will result in an annual revenue increase of $7.3 million for the test year. The effect of a 50¢ differential in flat rate residence FEX service from ZUM exchanges is included in the revenue effects associated with basic rates.

Both Pacific and the staff recommend a common rate with no allowance for business FEX lines and trunks. The proposed elimination of the allowance for business FEX lines and trunks is consistent with the staff's recommendation for a common measured business access line and measured business PBX trunk rate with no allowance which we will adopt.

The staff does not concur in Pacific's proposal to change the method of mileage measurement. Pacific's proposal would create a rate structure under which there would be large differences in rates for identical services. For example, under Pacific's proposal the mileage charge for an existing one-party residence FEX service involving three-fourths of a mile would remain unchanged at $4.80 per month per line; but a new customer requesting an identical FEX service would be charged $12.80 per month per line for mileage. Pacific's proposed changes in the application of mileage charges would result in a discriminatory rate structure and will not be adopted.

Both Pacific and the staff propose an increase in the service connection charges for FEX services, which, if adopted, would still recover only approximately one-third of the costs of providing FEX services. We will adopt the staff's proposed rates.

Foreign exchange services are optional services commonly selected by customers as an alternative to message toll service or ZUM service. As optional services, FEX services should not be provided at rates and charges substantially below cost. Present and proposed rates and charges for FEX services are residually priced. Pacific has not provided sufficient data to support cost based rates and charges for FEX services. The staff recommends Pacific be ordered to provide a study of all FEX services as a part of its next major rate application. In major rate proceedings Pacific should provide adequate rate studies. We will adopt the staff recommendation.

Multi-Element Service Charges

Service charges are made for various service functions performed such as installing a telephone, connecting the telephone at the central office, and taking the customer's order. Both Pacific and the staff proposed increases in these charges. At one time the service charges were based on a flat charge without regard to the actual work performed or service provided. More recently we have authorized service charges on a multi-element basis meaning each function is paid for by the customer. The rates proposed by Pacific and the staff are shown on Table 39.

TABLE 39

Multi-Element Service Charges

| | Present | Pacific Proposed | Staff Proposed And Adopted |
|---|---|---|---|
| Service Order | $ 7.00 | $10.00 | $10.00 |
| Central Office | 9.00 | 15.00 | 13.00 |
| Premises Visit | 8.00 | 8.00 | 6.25 |
| Interior Wiring* | 8.00 | 12.00 | 16.75 |
| Station Handling | 8.00 | 8.00 | 4.00 |
| Jack | 3.00 | 3.00 | 3.00 |
| Total | $43.00 | $56.00 | $53.00 |

* Charge per outlet installed.

The total charges listed on Table 39 would apply to a new customer for service if there were no wiring or jacks installed on the premises. However, some 70% of the residences in Pacific's exchanges are equipped with modular jacks. Also, customers can obtain a jack adaptor for terminal block application requiring no work by Pacific. When customers can take advantage of existing wiring, no premises visit is required, and customers can pick up telephones at a PhoneCenter, in such cases paying only the service order and central office charges when obtaining a new telephone service. These charges add to $16 at present rates, $25 at Pacific's proposed rates, and $23 at our adopted rates. In order to provide for full effectiveness of the PhoneCenter program, we are providing in this order that Pacific undertake a mandatory conversion of remaining residences to modular jack installations without charge to the customer.

A similar schedule of multi-element charges, at a slightly higher level applies to simple business service. Again, we adopt the staff-proposed charges. However, we will not at this time make any final adjustment in service charges for complex business services. Installation of services such as key telephone systems comes under the category of complex services. Since we are deferring **final rate changes for key telephone systems until we consider further the costing procedures, it is reasonable to defer final adjustment of complex service charges. Parties are placed on notice that such charges may be subject to adjustment in our final determinations in this proceeding.**

The objectives to be met in establishing appropriate levels of multi-element charges are fourfold:

1. They should be cost-related.
2. They should reflect the cost incurred by the utility for that customer.
3. They should be designed to encourage customer usage of PhoneCenter facilities.
4. They should relate directly to the work activities and be understandable to the customer.

We believe the primary emphasis should be placed on cost. Both Pacific and the staff used a cost study prepared by Pacific in response to Ordering Paragraph 11d of D.90642. The costs involved are directly assigned costs and do not involve the problems associated with the GE-100 costing method.

Pacific has proposed charges in excess of cost to encourage use of PhoneCenters. The staff based its charges primarily on costs. We adopt the staff proposal.

Station Sets

**The present rates for station sets differ depending on whether the set is a main telephone or an extension. Since the instrument is the same in either case we believe there is no justification for a difference. Both Pacific and the staff proposed a uniform rate. Pacific proposed a rate of $1.00 per month for a rotary set and $1.55 for a touchtone; the staff proposed $1.20 and $1.80, respectively. Also, Pacific proposed increases for the deluxe Princess and Trimline sets. The**

staff concurred in the Princess proposal but recommended no increase in the Trimline set. Pending review of terminal equipment costing methods we will adopt Pacific's proposal. In adopting these rates we take notice of the wide availability of FCC-registered telephone sets in the retail market. Many of these instruments sell for $25 or less, and may be attractive to customers who feel $1.00 per month is excessive. We note in this decision we are ordering a program to convert all residence premises to modular jacks at no charge to the customer. This will aid in allowing customers to purchase and use their own telephones.

Message Toll, WATS, ORTS, and OCMS

Pacific asks for a $91 million increase in message toll telephone service. The staff proposed a $42 million increase. Representatives of the non-Bell independents urged that a higher increase in toll rates be adopted. They noted the current low earnings on the toll service and the effect those earnings have on the independent companies. Pacific was concerned that an excessive increase in toll rates would not be desirable because of the competition that has developed in this area. Pacific also noted that intrastate toll rates are somewhat below interstate rates and that some increase was therefore warranted. We take notice of the action of the FCC which permitted AT&T to file a 16% increase in interstate rates effective July 9, 1981. Such an increase obviously aggravates the disparity between interstate and intrastate rates. Accordingly, we believe there is adequate justification to increase toll rates above the level proposed by either Pacific or the staff. Such an increase would correspond to the independents' position.

WATS, Optional Residence Telephone Service (ORTS), and Optional Calling Measured Service (OCMS) are all closely related to the message toll schedule. ORTS and OCMS are related to toll rates by a formula which has been used in the past.

We will allow these services to take their appropriate level according to the formula. As set forth in the following section on rate adjustments we are requiring Pacific to make studies looking toward expansion of ORTS.

WATS is a form of discounted toll service for relatively large users. While it is not tied to the toll schedule by a formula, it is cross-elastic with the toll schedule. Accordingly, we are providing for a WATS increase comparable to the message toll increase. We note the interstate WATS schedule structure has recently been revised to provide rates which vary with usage in a manner more closely related to costs than the previous schedule. We believe Pacific should study its intrastate WATS with a view toward developing a rate structure similar to interstate service. We will direct Pacific to make such a study and to submit a proposal within six months which will restructure the intrastate WATS along the lines of interstate WATS with rates that yield the same revenue as rates then in effect.

Proposition 13 Discount

The present tariffs of Pacific provide for a negative billing surcharge, or discount. This surcharge was instituted by Commission direction to provide a pass-through of property tax savings resulting from the passage of Proposition 13, the Jarvis-Gann tax initiative, in June 1978. A discount for tax savings is no longer appropriate since the results of operation we have adopted fully reflects actual property taxes paid including any savings. No useful purpose would be served to increase rates in other areas and still maintain a $77 million annual discount on rates. We are, therefore eliminating the surcharge to avoid having to increase other rates.

Modular Conversion Program
For Residence Services

Under the present residence modular conversion program, Pacific converts jacks and telephone sets to modular when service is terminated or a maintenance visit is made. All new service connections use modular jacks and telephone sets. This program basically involves modular conversion on customer-initiated activities. The present modular conversion program has no benefit for those customers who do not change their service or who never initiate a repair call. In addition, those customers are foreclosed from using customer-provided terminal equipment without incurring additional multielement charges from Pacific to convert the premises to modular jacks. As the rates and charges for utility-provided telephone sets continue to rise, the inequities compound for those customers who cause the utility no additional costs due to service order activity or repair calls. To correct this problem, the staff recommends Pacific be ordered to implement a modular conversion program for existing residence customers who have hardwired utility-provided telephone sets. Such a residence modular conversion program would have the goal of attaining the modular conversion of all simple residence services over a period of 24 months. The cost of this program is estimated to be approximately $13.5 million per year over a two-year period. This increase in expenses equates to an estimated increase in 1981 test year revenue requirement of $9.6 million. We will adopt the staff's recommendation and include a $9.6 million negative revenue requirement in the final rate spread. Details of the plan are set forth on pages 9 and 10 of Appendix F.

Interior Wiring (IW)
For Business Services

In A.58223 of Pacific, the staff recommended Pacific be ordered to provide cost studies on extensions and inside wiring as part of its next major rate application. In D.90642, the Commission adopted the staff's recommendation and ordered Pacific to provide a cost study for business inside wiring for extensions. In compliance, Pacific has provided cost information from which the staff has developed its proposed rates for business IW and extension services.

In our adopted service connection charges as proposed by the staff, the service connection charges associated with the provision of IW by Pacific are based on recovery of full cost. Therefore, it would be inequitable to continue monthly rates for Pacific-provided business IW. The staff proposes that the present monthly rates for Pacific-provided business IW be established at 30¢ per month, an amount which represents the costs associated with maintenance of business IW.

Coincident with the establishment of the 30¢ monthly rate, the staff recommends unbundling and restructuring all business extension services so that all telephone sets of similar type are provided at the same rate. For example, the present rate for a standard rotary PBX extension line with station is $2.00 in exchanges in which flat rate exchange access is provided and $1.65 in exchanges in which measured rate exchange access is provided. Each of these rates includes the telephone set and IW. Pacific indicates that the costs of providing a PBX station are the same as the costs of providing a standard business extension station, and that the costs of providing the IW for a PBX station and a standard business extension station are the same. Under the staff's proposed restructuring, a monthly rate of $1.00 would be applicable to all standard rotary stations used as PBX stations and business stations. Also, under the staff's proposal, a common monthly rate of 30¢ would be applicable to the utility-provided IW associated with PBX stations and business stations. The staff's proposal will simplify the present rate structure; therefore, we will adopt it and include the revenue requirement of $8.8 million in the rate spread.

Expansion of SMRT

In D.90642 as modified by D.90919 we authorized Pacific to implement SMRT in additional exchanges throughout the State. In lieu of the SMRT implementation schedule order in D.90642 and D.90919, Pacific proposes a revised schedule of SMRT implementation for residence services. Pacific indicates that the revised schedule more closely follows Pacific's programs of replacement of electro-mechanical central offices. It is Pacific's intent to rearrange the proposed schedule of SMRT implementation as necessary to achieve the most orderly and economical conversion of central offices. Under Pacific's proposal, the Commission would be notified at six-month intervals of the areas in which Pacific plans to implement SMRT looking two years into the future.

The staff supports Pacific's recommended revisions. As indicated by the staff the expansion of SMRT will provide the residence customer with a choice of one-party flat rate (1FR) service, one-party measured rate (1MR) service, and one-party message rate (1MQ) service (lifeline service) and is, therefore, a step toward usage-sensitive pricing in exchanges where it is not presently available. We believe the proposed revisions are reasonable and will provide for the orderly expansion of SMRT. Also, Pacific's recommendation to update the SMRT implementation schedule is appropriate. Pacific's recommendations will be adopted.

Because 1MR and 1MQ services are priced at less than flat rate residence services, Pacific will experience a revenue loss when customers convert from flat rate service. To cover this loss we are including $0.6 million of revenue requirement in our rate spread for the test year.

The staff indicates that the SMRT expansion program proposed by Pacific does not include the elimination of flat rate business services nor the offering of measured rate business services. In order to further growth of services which incorporate usage-sensitive pricing, the staff recommends that the Commission order Pacific to include as a part of its next major rate application a study on implementing measured services for businesses in all exchanges where residence 1MR and 1MQ services are offered. The staff recommends that such a study contain an implementation schedule, the revenue requirement, and a proposed tariff schedule. The staff further recommends that Pacific be ordered to provide the proposal as an alternative rate design in its next major rate application and that all customers who could be affected be notified that such a tariff is being considered by the Commission. The staff's recommendation is a reasonable step toward achieving statewide usage-sensitive pricing for telephone services and should be adopted.

Expansion of ORTS

ORTS as presently offered in the San Francisco Bay Area and the Los Angeles-Orange County area provides for optional calling for residence customers over routes up to and including 40 airline miles in length. ORTS provides residence customers with a discount over message toll and/or ZUM rates. On or before March 31, 1981, a fully measured ORTS rate structure was implemented by Pacific on all present ORTS routes for ORTS calls originating in Pacific's exchanges. This fully measured ORTS structure consists of two basic plans. The Community Calling Plan allows the customer to purchase discounted rates for calling over routes from one point to another. The Circle Calling Plan allows customers to purchase discounted calling to all points within a 40-route mile circle of the customer's local exchange or district area.

As discussed by the staff the present areas in which ORTS is offered have not been revised since ORTS was first established about 10 years ago. The staff further indicates that customers perceive the present ORTS service areas and structure to be unfair in that those customers located in exchanges within 40 route miles beyond the areas where ORTS is offered on an "out" basis can be called by a customer using "out" ORTS but must return a call to the same customer under message toll rates. For these reasons, the staff suggests that consideration be given to revising the areas in which ORTS is presently offered. However, any future revisions to the areas in which ORTS is offered will require cooperation and coordination among the utilities involved. The staff indicates that the facilities and customers of Continental, Citizens Utilities Company of California (Citizens), General, and Pacific would be involved in the possible expansion of the offering of "out" ORTS from the exchanges which presently receive "in" ORTS calls.

In order to analyze the possibility of expanding ORTS, the staff recommends the Commission order Continental, Citizens, General, and Pacific to present exhibits and testimony in Pacific's next major rate case covering the expansion of ORTS into exchanges which presently receive "in" ORTS only. The staff suggests the exhibits and testimony address the feasibility of implementing ORTS over the additional routes, the revenue requirement in terms of added plant, and additional expenses associated with the expansion of

ORTS over the additional routes. The staff further recommends that each utility provide proper written notice to customers who would be affected by the plan prior to submission of the testimony and exhibits.

We believe the staff's recommendations have merit and will provide the necessary information for us to give further consideration to the possible expansion of ORTS, including input from customers who could be affected. We will adopt the staff's recommendations.

Expansion of ZUM

ZUM was first established in compliance with D.90642 and 90919 in A.58223 of Pacific. ZUM as a rate structure incorporates the call measurement elements of frequency, time-of-day, duration, and distance. The structure of message toll service also incorporates these same four measurement elements, and therefore, as with message toll service, ZUM also represents total usage sensitivity. The usage-sensitive pricing nature of the ZUM rate structure provides the most equitable form of pricing to the user. ZUM is presently offered in the San Francisco-East Bay Extended Area (SF-EBEA) and the Los Angeles Extended Area (LAEA).

In order to achieve further development of usage-sensitive local service, the staff recommends that the implementation of ZUM be considered for four additional areas, (1) Orange County Extended Area (OCEA), (2) San Diego Extended Area (SDEA), (3) Sacramento Extended Area (Sacto EA), and (4) the exchanges of Pomona, Ontario, and Etiwanda (L.A. Metro Exchanges). In Exhibit 242 the staff presented proposed routes for these four areas based on the same criteria on which present ZUM routes in the SF-EBEA and LAEA were established. The staff, however, is not recommending the expansion of ZUM in this proceeding because data are not available to enable the staff to recommend such expansion.

As indicated by the staff, expansion of ZUM in the areas noted will require the cooperation and coordination of Pacific and General as well as Roseville Telephone Company (Roseville) and Citizens. Also, the staff suggests that comments from customers affected should be considered before such an expansion. Therefore, staff recommends the Commission order Pacific, General, Roseville, and Citizens to present exhibits and testimony in Pacific's next major rate case covering implementation of ZUM in the four additional areas noted. The staff suggests that such exhibits and testimony address the feasibility of ZUM implementation for each additional area, the revenue requirement in terms of added plant, and additional expenses associated with the implementation, and written notice to affected customers at the time the testimony and exhibits are submitted.

We believe the staff recommendations for studying the expansion of ZUM have merit and should be adopted.

Settlement Effects on Other Utilities

Since all telephone utilities in California operate under the uniform statewide schedule of toll rates filed by Pacific, the increase we are authorizing for toll services will affect the independents. All utilities will bill their customers at the uniform rates and moneys collected are credited to the statewide pool of funds. As discussed earlier in this decision, each utility receives its costs of providing toll service plus a return on its plant allocated to toll through the settlements process.

Similar settlements are applicable to extended area service offered by two companies. Where the settlements are with Pacific, an increase in Pacific's exchange rate of return will result in an increase in settlement revenues to the independent. There is also a settlement between Pacific and General for ZUM service. Other settlements exist for other services such as mobile telephone service and private line service. Table 40 summarizes the settlement effects resulting from this decision.

TABLE 40

Settlement Revenues to Independent Telephone Companies

Year 1981 Annual Basis

(Dollars in Millions)

| Utility | Toll | Exchange | Total |
|---|---|---|---|
| General | 72.6 | 8.2* | 80.8 |
| Continental | 8.9 | .1 | 9.0 |
| All Other | 8.0 | 1.2 | 9.2 |
| Total | 89.5 | 9.5 | 99.0 |

* Includes ZUM

The rates we are authorizing for Pacific will result in increased settlement revenues for all the independents in California. In some instances such increased revenues could result in excessive earnings for an independent. In other instances it may help to forestall the requirement for rate increases. For the bulk of the independents, we will direct our staff to monitor the earnings of such companies, most of which have not had rate increase applications before the Commission for many years.

General and Continental represent special cases. General is now before us with A.60340. In that proceeding we will determine the effects of increased settlements on General's operations, and we will make appropriate adjustments to General's revenue requirements to reflect such settlements.

Continental was most recently before us with A.59936 which resulted in D.92804 dated March 17, 1981, wherein we authorized an annual revenue increase of $9,232,000 based on a 1981 test year. In that decision we noted, "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." This finding was reflected in Ordering Paragraph 7 of D.92804. Accordingly, we are providing in this decision for an adjustment of Continental's surcharge to reflect increased settlement revenues of $9 million.

One additional area of intercompany operations is the provision of FEX service. Where an independent furnishes FEX from a Pacific exchange it pays Pacific the rate applicable in Pacific's exchange. As Pacific's rates are increased the charges to independent companies will be increased. Accordingly, we will provide that independent companies may file revised FEX tariffs to reflect the pass-through of Pacific's increased rates.

Mobile Telephone Rates

Allied Telephone Companies Association (Allied), representing the majority of California's radiotelephone utilities, appeared in these proceedings to focus attention on whether or not the mobile telephone service equipment and installation rates charged by Pacific are fully compensatory. Allied contends that Pacific's mobile telephone rates are noncompensatory and that Allied's members, as competitors of Pacific, suffer as a result. In D.88232 dated December 13, 1977 in A.55492, the Commission found that Pacific's manual mobile telephone offerings were noncompensatory and ordered Pacific to convert to a system that would bill customers for actual air time used rather than for only conversation time. Also, Pacific was ordered to convert its manual offering to improved mobile telephone services (IMTS) no later than December 13, 1979. At Pacific's request the December 13, 1979 date was extended to June 13, 1980 by D.90658, to June 13, 1981 by D.91858, and to June 13, 1982 by D.93135 dated June 2, 1981. D.91858 was issued in connection with OII 20 which dealt generally with Pacific's mobile telephone offering. In the OII 20 proceeding Allied sought additional cost information designed to support its contention that Pacific's mobile telephone rates were noncompensatory. In response to Allied's request, Pacific filed Exhibit 13 relating to the physical configuration of Pacific's proposed IMTS offering and certain costs of service. D.91858 reiterated the Commission's earlier order that Pacific change over to an air time billing system and that Pacific on or before August 1, 1980 prepare and file with the Commission a fully allocated earnings study of its mobile telephone service operations. The air time portion of that order was later deleted by D.92053 but the requirement that an earnings study be filed was not. Pacific's response to the earnings study requirement was a "manual mobile telephone study" which indicated that in 1977 and 1978 Pacific's manual mobile offering was noncompensatory. In view of the anticipated conversion to IMTS no similar study was done for 1979.

Pacific filed Advice Letter 13779 on December 30, 1980 increasing equipment and installation rates for its mobile telephone service and announcing its intention to introduce a "radio link charge" at the time of conversion to IMTS. Pacific believed the total conversion to IMTS would be accomplished by June 13, 1981. However, because a revenue requirement study has not yet been done, Pacific is not in a position to apply for increased rates for its IMTS service, and believes it would be premature for the Commission in this general rate proceeding to inquire into its IMTS service rates. Allied believes it would be best to examine Pacific's mobile rates for service, equipment, and installation in a proceeding designed specifically for that purpose.

Accordingly, during this proceeding by letter to the ALJ, Pacific and Allied have agreed that:

1. Pacific will respond to some data requests by Allied with the exception of certain documents alleged by Pacific to be proprietary in nature with Allied reserving its right to seek disclosure.
2. Allied will withdraw from the current rate proceeding insofar as it relates to mobile telephone rate questions.
3. Pacific will accelerate its efforts to produce a revenue requirement study relating to its IMTS offerings and will furnish a copy to counsel for Allied when it has been completed.
4. Within seven weeks of its conversion to IMTS Pacific will file a rate increase application for its IMTS service.
5. In the event Allied appears in that proceeding, Pacific will not oppose Allied's request that the Commission address Pacific's equipment and installation rates as well as the service rates relating to IMTS.

Other minor matters were stipulated to by Pacific and Allied concerning the mobile telephone service. For purposes of this proceeding, we adopt the stipulation.

Other Issues

Several other issues require discussion. These are:

1. Staff's audit report accounting recommendations.
2. Accelerated depreciation.
3. Equipment depreciation rates.
4. LA County - entrance channels.
5. Amendment of GO 96-A.
6. Allowance for attrition.

Staff's Audit Report

The staff's audit report proposes that Pacific maintain separate records of legal and other departmental expenses related to equal employment opportunity (EEO) litigation so that such costs can be identified. The staff also proposes that these costs be disallowed for ratemaking purposes. D.88232 (1977) 83 CPUC 149, 213, from which the staff derives this proposal, (Exh. 250, pp. 2-10, ¶ 111) states that an earlier disallowance was limited to certain penalty payments and does not include amounts connected with litigation of Equal Employment Opportunity Counsel (EEOC) problems. In D.88232 (1977) 83 CPUC 149, 213, the Commission said:

> "We are simply not convinced that the payments to employees pursuant to the consent decree to compensate for alleged discriminatory practices are reasonable ones to pass on to ratepayers. The U.S. Supreme Court has reached the same conclusion in NAACP v FPC, 48 L.Ed 2d 248, p.292 (1976). We emphasize that our disallowance is limited to the penalty payments to employees, and does not include amounts connected with litigation of EEOC problems, administration of EEOC programs, or compliance with the consent decree".

Pacific claims that like Pacific's argument on the antitrust expenses the Commission should allow legitimate operating expenses reasonably incurred for legal and litigation matters. To otherwise disallow such expenses relating to suits brought against Pacific inhibits Pacific's constitutional rights. Pacific further argues that the impropriety of such a disallowance is supported by the very nature of the Civil Rights Act under which such litigation is initiated. A plaintiff in EEO litigation has a right to bring such an action even if the EEOC has determined that there is no reasonable cause to believe that the charge made by the plaintiff is true (42 USC Section 2,000-e-5).

Witness Louie, on cross-examination, cited the recent D.92549 in Southern California Edison's rate case. There the Commission disallowed certain EEO costs of Edison on the basis that they resulted from a past discriminatory practice. This was established by the Commission on the assumption that a settlement offer by Edison in the EEO suit in question would be accepted by the plaintiffs (Southern California Edison Company, D.92549 1980 mimeo. p. 40). Pacific believes no such assumption is applicable in this proceeding. Louie conceded he would allow EEO administrative costs; Pacific points out that since it has over 110,000 employees, EEO administration is certain to entail some controversy which is a normal part of doing business. Also, Pacific says that the staff failed to address in any way the extra cost of carrying out its proposal for special accounting and record-keeping and that such costs would be burdensome and should not be required. We note that the Commission in C.10308 is presently investigating equal employment and contracting practices and their relationship to rates; Pacific is a respondent in that case. A decision in this proceeding on the issues of separate EEO accounting and disallowance of all EEO operating expenses may be premature given our pending investigation. Therefore, we reserve a ruling on these issues, until the matters we are continuing for further hearing are concluded.

The staff proposed that Pacific make changes on its books of account in two instances where there is no dispute over the ratemaking treatment for the items involved. The two items are Chamber of Commerce dues and other donations, and interest during construction and property taxes on land. (Exh. 250 pp. 2-3 to 2-7, ¶ 113). Witness Louie agreed that Pacific must follow the FCC prescribed Uniform System of Accounts in its books of accounts.

On the first of these items, accounting for Chamber of Commerce dues and taxpayer association dues, Pacific claims these costs belong in Account 675 not Account 323 as proposed by Louie. Louie claims that the charges belong in Account 323 because they are not operating expenses in the first place. (Tr. 6929, ¶ 115.) Pacific points out that operating expenses as such are not defined by the Uniform System of Accounts but all expenses are classified in individual accounts, i.e., Account 675 includes expenses for association dues. Louie cited D.84902 of PG&E, to bolster his recommendation on the dues and membership costs. Pacific points out that gas and electric utilities are subject to a different uniform system of accounts than telephone companies and that decision should not be a precedent for what Pacific can do on its books.

Louie made a similar recommendation for the accounting treatment for interest during construction and property taxes on land. In D.88232 the Commission prescribed a particular treatment for interest during construction and property taxes for land on which construction is taking place. Louie agrees that Pacific has followed that treatment for ratemaking purposes in this proceeding and that the FCC has not authorized the changes prescribed by D.88232. Pacific claims that since this is the case no change in the method of treating these charges related to land is appropriate for accounting purposes. Again we agree with Pacific.

Accelerated Tax Depreciation

In 1954, Section 167 of the Internal Revenue Code gave corporations the option of using straight-line depreciation or accelerated depreciation for income tax purposes. Pacific postponed until 1970 use of accelerated depreciation for tax purposes, one of the few major public utilities in California to do so. An indication of the effect of accelerated depreciation on Pacific's taxes was noted in D.74917 issued November 6, 1968 in A.49149, a general rate application of Pacific:

> "The record show[s] that for the period 1954-67 Pacific's taxes would have been $225,000,000 less if it had used accelerated depreciation for the entire period." (69 CPUC 61.)

The results of operations adopted for ratemaking in D.74917 imputed the use of accelerated depreciation for income tax purposes for the test year with a "flow-through"[15/] of the potential but unrealized tax savings to ratepayers.

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15/ Two important terms used in any discussion of this issue are "flow-through" and "normalization". Normalization means imputing income taxes for ratemaking purposes as though no tax credit were taken for (a) the additional depreciation allowed through accelerated depreciation and (b) the direct decrease in taxes resulting from investment tax credits. Flow-through means using actual taxes paid for ratemaking purposes thereby flowing benefits through to the ratepayers. Appropriate adjustments to rate base are made under both concepts.

In 1969 an important change in tax law was enacted. Section 441 of the Tax Reform Act of 1969 provided that utilities which had not used accelerated depreciation prior to August 30, 1969 would not be allowed to take accelerated depreciation unless normalization was used in fixing the utilities' costs for ratemaking purposes. After August 30, 1969 Pacific elected to take accelerated depreciation.

A subsequent decision of the Commission employed normalization but the State Supreme Court in City and County of San Francisco v PUC (1971) 6 C 3d 119 annulled the Commission's order and instructed the Commission to seek a solution between the extremes of flow-through and normalization.

As a result, the Commission in D.87838 (1977) 82 CPUC 549, the so-called "tax remand order", adopted the "average annual adjustment" (AAA) method for treatment of accelerated depreciation. AAA makes an adjustment equal to a four-year average of the rate case test year adjustment and the estimated adjustments for the subsequent three years. A similar adjustment called "AA" is made for investment tax credit. After considerable litigation involving the California Supreme Court, federal appellate courts, and the U.S. Supreme Court, D.87838 was upheld. (See Appendix G for a history of the accelerated depreciation issue.)

However, the IRS has ruled that Pacific is ineligible to use accelerated depreciation if the Commission uses AAA/AA for ratemaking.

D.91337 issued February 13, 1980 employing the methods adopted in D.87838, ordered refunds to Pacific's customers for the period August 1974 through February 1980 amounting to some $381 million.

D.91337 authorized prospective rates on the basis of full normalization subject to refund[16] pending the outcome of litigation with the IRS on the question of Pacific's continued eligibility for accelerated depreciation if the Commission uses the AAA/AA method for ratefixing. The purpose of permitting full normalization was to preserve Pacific's eligibility while Pacific pursued that eligibility with the IRS. The Commission did this, of course, under the assumption that Pacific would use good faith efforts to retain eligibility to use the AAA/AA method. At the same time the Commission warned Pacific that failure to use good faith would result in a reversion to the AAA/AA method. With regard to litigation we stated:

> "In judging whether the good faith effort is undertaken, the Commission will look to the following: The willingness of the companies and special counsel to report to the Commission on the progress of litigation; the willingness of the companies to support the Commission as full partner and intervenor in the litigation; and the degree to which actions of special counsel and oversight of special counsel are undertaken independent of those elements of Pacific which continue to claim that eligibility is lost under Decision No. 87838."

16/ Under normalization the potential reduction in taxes by using accelerated depreciation is calculated, noted in a reserve account, and deducted from rate base for ratemaking purposes. A portion of the tax savings is subject to refund based on the AAA/AA method adopted in D.87838. If the AAA/AA method were used in this proceeding, the gross revenue requirement for 1981 would be reduced by about $80 million.

After several motions by the parties and Pacific, all properly ruled on by the ALJ,[17/] with some, at the request of Pacific, reviewed by the assigned Commissioner, the ALJ ordered Pacific to produce a witness to testify how Pacific has, in good faith, pursued retention of its eligibility. In response, Pacific called Robert DiGiorgio, a director of Pacific and member of Pacific's special tax litigation committee which was formed in August 1969. DiGiorgio testified that he believes the IRS ruling is final and Pacific has no choice but to accept it. Concerning litigation, Pacific hired a special counsel to seek resolution of the conflict with IRS through legal action. The counsel advised the tax committee that in his opinion there was less than a 50/50 chance of winning. DiGiorgio stated that the officers and directors of Pacific felt the same way. Therefore, the committee directed the special counsel, after some initial legal work on the matter, to suspend his efforts pending outcome of proposed legislation.

Legislation supported by AT&T had been introduced by California delegates in last year's Congress to remove any back-tax liability which, as of September 30, 1980, amounted to \$1.362 billion, and prevent this Commission from using the AAA/AA method for ratemaking in the future. That legislation passed the House of Representatives but not the Senate. Although the Commission favored the forgiveness of past tax liability, it opposed the bill because it did not provide a prospective solution. The Cities of San Francisco, Los Angeles, and San Diego also opposed the legislation. The bill has been reintroduced in the current Congress and its outcome is pending. (H.R. 1524, S.232.) The Commission did not take a position on the current bill; nor did the cities.

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17/ At the outset, San Francisco moved to have the entire issue of accelerated depreciation included in these proceedings. This was denied by the ALJ and we concur. The ALJ did, however, allow in the issue of whether Pacific has acted in "good faith" to preserve its eligibility. We concur in that ruling also.

It appears Pacific had two basic options available to it - litigation or legislation. The record indicates Pacific weighed these options and determined to support congressional legislation which would forgive the back tax liability. Such forgiveness is definitely in the interests of Pacific's ratepayers.

Obviously, as noted above, this Commission would have preferred legislation which also affirmatively declared AAA/AA to be legitimate normalization methods. To this end the Commission urged that the 1980-81 "forgiveness" bill be amended to include such a declaration. It is fair to say there was little enthusiasm for our proposal in Congress.

The 1981-82 Congressional session adds a new dimension to the problem of ratemaking treatment of tax savings or deferrals. Both the Senate and House versions of the President's tax proposals contain language which would attempt to restrict the ratemaking treatment which can be applied to tax savings generated by the Act. These restrictions would apply to all utilities, not just the telephone companies.

While we are certainly not totally satisfied with Pacific's action, or lack thereof, we cannot conclude, given the alternatives available, that Pacific has thus far acted in bad faith. Because of the enormity of the possible financial consequences to Pacific and the eventual effect on its ratepayers as well, we are most reluctant to impute the AAA/AA method unilaterally.

In order to pursue litigation Pacific must file a claim for refund with the IRS by February 4, 1982 (Exh. 59, Internal Revenue Code Section 6511(a)). Pacific is placed on notice that if H.R. 1524/S.232 were not to pass, and Pacific failed to preserve its rights to litigate the issue, we would have to conclude that Pacific had not acted in good faith.

Equipment Depreciation Rates

As discussed under the subsection on depreciation in the section on expenses, we have reservations concerning the depreciation rates (remaining life) we have authorized for Pacific's plant. The overall undepreciated investment is above 80% of the original plant cost which seems unusually high. New equipment such as electronic switching systems are being assigned total lives of 36 years which seems unusually high. In view of the further hearings we will have on costing procedures, it would fit in to have also a review and comments on plant depreciation practices. Accordingly, that will be a subject of the further hearings.

LA County - Entrance Channels

LA County claims there is a failure in the revenue estimates offered to account for the effect of proposed private lines and channel charges on Centrex off-premises mileage, an understatement of $16.3 million. Because of the way we will apply the increase in this proceeding, we find that not to be a factor.

LA County requests that entrance channels should be made available in the same manner as any other equivalent private-line facility. It claims entrance channels are presently priced in an arbitrary and capricious manner and the existing procedure for establishing entrance channels is excessively lengthy and time-consuming. LA County asks that entrance channels be made available at the same price and on the same basis as any other private-line service of the same grade and class.

We will expect Pacific and LA County to work out the problems discussed above and if the solution is not satisfactory to LA County it can bring the matter to our attention in the further hearings to be held.

Amendment of GO 96-A

William R. Haerle, attorney for the independent telephone companies, requests a revision to GO 96-A so that all the smaller independents can increase nontoll rates without filing formal applications. The revision would include an increase from $750,000 to $1,000,000 in the present GO 96-A limitation as well as an annual review of the limit to reflect inflation.

We are sympathetic with the request but believe it should be made formally on this record in connection with OII 81 so all parties may have a chance to respond. We will provide appropriate time during the further hearings.

Allowance for Attrition

Pacific believes the Commission should deal with Pacific's problem of attrition[18/] as it has done for other utilities in the past. The major causes of attrition are higher investment requirements, wage increases, and general inflation in 1982, the year subsequent to the adopted rate year. Pacific suggests there are several ways the Commission could grant attrition allowances.

An adjustment in the rate of return is the simplest and most effective and has been done by the Commission in the past. (Southern California Water Company, D.91024, mimeo. p. 11, November 20, 1979; PG&E Company, D.91107, mimeo. pp. 68-69a; San Gabriel Water Company, D.88271, mimeo. p. 15, December 20, 1977; Cal Water Service Company, D.89108, mimeo. pp. 12-13, July 25, 1978.) Pacific suggests the erosion in earnings could be accounted for by providing a step-up in rates based on a rate of return adjustment (see City of Los Angeles v Public Utilities Commission (1975) 15 Cal 3d 680, to be effective on January 1, 1982).

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18/ Attrition is the diminution in earnings due to changes in estimated expenses during years subsequent to the rate year upon which results of operations are based.

Another method would be for the Commission to permit automatic rate adjustments in 1982 for the following items: (a) increased cost of energy supplies, (b) nonmanagement wage increases and corresponding increases and benefit expenses related to the cost-of-living index, and (c) unusual events having substantial impact on operating expenses. While the second alternative would require the presentation of some showing before the Commission a simple adjustment mechanism based on actual data could provide a basis for the rate relief.

We are not sympathetic with Pacific's proposal and will not adopt it. First, we are basing our adopted rate of return on December 31, 1981 estimated capitalization ratios and finance costs. This is a partial recognition of attrition. Second, Pacific did not analyze how productivity improvements might offset the attrition in the expense categories it has identified. We would consider more fully developed proposals for financial and operational attrition in Pacific's next general rate proceeding.

Findings of Fact

1. Pacific filed this application in compliance with the requirements of Resolution M-4706 and the Commission's Regulatory Lag Plan.

2. Pacific requests an annual increase in revenues of $789,800,000.

3. On August 19, 1980 the Commission on its own motion instituted OII 81 which is an investigation into Pacific's operations and those of all other telephone companies in California for the purpose of reviewing the rates, tolls, rules, charges, operations, costs, separations, intercompany settlements, practices, contracts, service, and facilities of Pacific and the independents.

4. Properly noticed public hearings were held in this matter between August 8, 1980 and April 9, 1981 and all parties including the public were given an opportunity to participate.

5. In general, the estimated results of operations by the staff for the test year 1981 should be adopted because they are based on later data than those used by Pacific for its estimate and, for the most part, are concurred in by Pacific.

6. The results of operations estimated by Pacific for the test year, coupled with Pacific's requested overall rate of return of 13.47%, would require a gross revenue increase of $825,400,000.

7. The staff's results of operations for the test year, coupled with the staff's rate of return recommendation of 11.50% would require a net taxable revenue increase of $261,600,000.

8. Except for a downward adjustment of $54 million, the staff's estimate of operating revenues for the test year is reasonable and should be adopted because it is based on later and more up-to-date information than that used by Pacific.

9. The staff's revenue reduction estimate of $63,725,000 for the effect of PhoneCenters on service connection charges is reasonable.

10. With the exceptions noted in the findings which follow, the staff expense estimates should be adopted because they correspond to the staff revenue estimates, reflect the staff's overall view of 1981 operating levels, and are based on later and more up-to-date information than that used by Pacific.

11. An estimate for test year maintenance expenses of $1,611,700,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $1,569,500,000 |
| Adjust for: | |
| a. COE Changes, A/C 604 | +2,700,000 |
| b. Repairs of Station Equip. | +29,900,000 |
| c. Maintaining Transmission Power, A/C 610 | +2,200,000 |
| d. Affiliated Interests | +7,200,000 |
| e. Rounding | +200,000 |
| Total Adopted Maintenance Exp. | $1,611,700,000 |

12. The estimate for test year depreciation expense of $853,300,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $852,600,000 |
| Adjust for: | |
| a. Affiliated Interests | +300,000 |
| b. Modernization | +400,000 |
| Total Adopted Depreciation Expense | $853,300,000 |

13. An estimate for test year traffic expenses of $406,500,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $406,300,000 |
| Adjust for: | |
| a. Stockton Office | +300,000 |
| b. Rounding | -100,000 |
| Total Adopted Traffic Expenses | $406,500,000 |

14. An estimate for test year commercial expenses of $708,900,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $706,100,000 |
| Adjust for: | |
| a. Three Manager Positions | +200,000 |
| b. Business Service Center Improvements | +3,100,000 |
| c. Advertising (Openline) | -500,000 |
| Total Adopted Commercial Expenses | 708,900,000 |

15. An estimate for test year general office salaries and expenses of $363,400,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $355,600,000 |
| Adjust for: | |
| a. Accounting Dept. | +4,500,000 |
| b. Postage | +3,300,000 |
| Total Adopted General Office Salaries and Expenses | $363,400,000 |

16. An estimate for test year other operating expenses of $747,800,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $675,000,000 |
| Adjust for: | |
| a. Relief and Pensions | +70,500,000 |
| b. License Contract | +2,000,000 |
| c. Pioneer Activities | +200,000 |
| d. Rounding | +100,000 |
| Total Adopted Other Operating Expenses | $747,800,000 |

17. An estimate for test year taxes other than income taxes of $263,500,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $262,800,000 |
| Adjust for Adopted Expenses | +700,000 |
| Total Adopted Taxes Other Than Income | $263,500,000 |

18. The relationship of the latest five years actual tax to statutory tax times the statutory rate is a reasonable method for calculating California corporation franchise taxes.

19. The staff's method for calculating additional California corporation franchise tax liability resulting from increased revenues from adopted rates is reasonable.

20. The staff's net-to-gross multiplier of 1.896 is reasonable.

21. Calculating Federal Income Tax based on a full normalization basis subject to refund upon completion of the litigation with IRS concerning the use of the AAA/AA depreciation methods for ratemaking purposes is reasonable and is consistent with D.91337 dated February 13, 1980.

22. Billings to Pacific for work done by Bell Labs through the License Contract Expense Agreement of $22,700,000 for the test year are reasonable.

23. A billing to Pacific for return on investment of the 195 Broadway Corporation of $3,500,000 for the test year is reasonable.

24. The staff's recommendation for an adjustment to license contract expense billings of $19,107,000 because of AT&T and Pacific organizational realignments related to the FCC Computer II decision is reasonable for this decision.

25. A license contract expense billing by the AT&T General Department to Pacific of $31,300,000 for the test year is reasonable.

26. Disallowed license contract product-related costs should be reflected in Western's pricing practices.

27. Pacific's request to reduce Western's net income by the disallowed license contract product-related costs without reflecting such costs in the pricing of products should be denied.

28. A billing by Bell Labs of $18,441,000 to Pacific for development of business information systems for the test year is reasonable.

29. A net reduction of $134,900,000 to Pacific's rate base for Western Electric adjustments is reasonable.

30. A reduction of Pacific's expenses by $12,800,000 for Western Electric adjustments is reasonable.

31. An estimate for test year rate base of $11,589,800,000 is reasonable and, as explained in this decision, is derived as follows:

| | |
|---|---|
| Staff Estimate | $11,625,300,000 |
| Adjust for: | |
| a. Plant - Affiliated Interests | +4,900,000 |
| b. Plant - Modernization | +15,800,000 |
| c. Plant - IDC Interest | +4,100,000 |
| d. Working Cash Allowance | -58,200,000 |
| e. Materials and Supplies | +3,000,000 |
| f. Depreciation Reserve | +1,300,000 |
| g. Reserve for Deferred Taxes | +3,900,000 |
| h. Rounding | +100,000 |
| Total Adopted Rate Base | $11,589,800,000 |

32. Monthly compounding of IDC is reasonable and should be adopted effective January 1, 1981.

33. D.91495 in A.59269 granted Pacific an interim rate increase of $227.2 million with rates subject to refund pending a determination in this proceeding of the reasonableness of the increase.

34. Included in the $227.2 million increase granted by D.91495 was $69.4 million for the purpose of offsetting additional marketing expenses for competitive terminal equipment.

35. Pacific did not use the $69.4 million specifically for the purpose the Commission intended.

36. D.91495 established 10.25% as a reasonable rate of return for Pacific for the test year 1980.

37. Table 26 indicates Pacific attained an 8.95% return in 1980 before the usual adjustments for ratemaking purposes.

38. Based on the results of operations shown on Table 26 and considering the possible adjustments to those results for ratemaking purposes including the $69.4 million noted in previous findings, Pacific would not have attained a rate of return in 1980 of 10.25%.

39. The revenue increase and rates authorized by D.91495 in April 1980 are justified and are just and reasonable.

40. It is reasonable to allow Pacific to retain the $69.4 million granted in D.91495 because of the earnings level shown for 1980 on Table 26.

41. In making its estimates for the 1981 test year, the staff found no unproductive marketing effort which would require a special treatment of Pacific's marketing expenses similar to that recommended by the staff in its estimates for the 1980 test year in A.59269.

42. Reflecting previous findings, the estimated results of operations under present rates for test year 1981 total operations and California intrastate operations shown on Table 25 are reasonable.

43. Pacific has an A bond rating by Moody's and an A- by Standard and Poor's with a possibility of downgrading unless earnings and coverages improve.

44. A downgrading of Pacific's bond ratings will make it very difficult for Pacific to raise sufficient capital to meet its 1981-82 construction budgets.

45. Some recent debt security issues of Pacific and other utilities have cost about 16% or more.

46. The Commission should adopt a rate of return for Pacific based on all the evidence before it in this rate case and should not rely on a single formula or method.

47. The action of AT&T not to purchase common stock shares of Pacific from 1973 to 1980 contributed to a considerable degree to the present unsatisfactory financial condition of Pacific.

48. AT&T and Pacific should join with the Commission in a new spirit of cooperation to improve Pacific's debt/equity ratio and general financial condition.

49. The capitalization ratios for the test year recommended by the staff and concurred in by Pacific and shown on Table 29 are reasonable.

50. A rate of return for the test year of 12.91% overall which incorporates a return on common equity of 17.4% is reasonable.

51. The adopted rate of return of 12.91%, coupled with the adopted rate base for intrastate operations of $8,650,000,000, produces a net increased revenue requirement for the test year of $321,800,000 which, when multiplied by the staff net-to-gross multiplier of 1.896, results in an additional gross revenue requirement of $610,100,000.

52. Pacific's overall service performance level stabilized in 1979 and showed improvement in 1980, and, in general, Pacific is providing adequate service.

53. Network services in southern California and overall service in the Los Angeles sector have deteriorated over the years and currently are at less than desirable levels.

54. There are serious problems with the service of Pacific in repairing and installing private line services.

55. A committee should be established with representation from the alarm industry, Pacific, and the staff to determine and recommend reasonable standards for the installation and repair of private line services used by the alarm industry.

56. The committee referred to in the previous finding should incorporate its recommendations into a proposed general order and present it to the Commission.

57. The reports and plans for improving service performances required of Pacific by D.90642 have been provided by Pacific and no further action by the Commission is required in this proceeding.

58. The FCC by its decision in the Computer Inquiry II has ordered deregulation of telephone terminal equipment by March 1, 1982 and this will require AT&T and the OTCs to form fully separated terminal equipment operations to handle the deregulated activities.

59. Costs associated with the unregulated operations ordered by the FCC must be borne by those operations, and terminal equipment investment and reserves left with the regulated operations should reflect accurately the remaining physical plant necessary to serve the regulated operations.

60. The Bell System has engaged in a so-called migration strategy which is a product-pricing strategy designed to:

a. Improve product line contribution to revenue.

b. Establish prices for new products and reprice older products.

c. Migrate (move) present customers to new products.

d. Prepare customers for the next generation of products.

e. Position the Bell System as the market leader in the competitive telecommunications/information systems market.

61. AT&T directed the OTCs, including Pacific, to engage in an aggressive marketing program designed to secure embedded equipment market customers against competition; Pacific carried out the program through the addition of substantial numbers of personnel, new training programs, and incentive compensation programs.

62. Some of the costs of the migration strategy programs could be recovered as short-term expenses from existing ratepayers of regulated services even though the benefits will be realized mainly subsequent to deregulation of terminal equipment in March 1982 by the unregulated operations.

63. The migration strategy may result in stranding investment of retired plant thereby requiring that stranded investment to be paid off by future ratepayers of regulated operations.

64. Present Pacific ratepayers are paying for research and development, training, and sales efforts connected with equipment which may be installed after March 1, 1982 and, thereby, become a part of the investment in the deregulated operations.

65. Pacific should not be allowed to adopt marketing or pricing practices, the purpose of which is to accomplish post-deregulation market positioning, if such practices result in unwarranted rates for customers of installed base equipment or create a residue of stranded investment to be recouped from the regulated operation's ratepayers.

66. Although we find Pacific embraced the migration strategy, the record is not clear whether Pacific used the pricing concepts suggested by AT&T.

67. Further hearings should be held to determine an appropriate method of allocating to the proper user any net stranded investment as a result of Pacific's migration strategy and the establishment of nonregulated operations on March 1, 1982, as required by the FCC Computer Inquiry II decision.

68. Further hearings should be held to determine the costs, both capital and expense, of establishing the nonregulated operations referred to in the previous finding.

69. Pacific and the staff should expeditiously determine the kinds, if any, of equipment that have been retired prior to being fully depreciated, the associated amount of undepreciated or stranded investment, and a method for recovering fairly any stranded investment, and present their findings at further hearings.

70. Pacific should be ordered to:

a. Account for all expenses incurred to date relating to existing and future enhanced service offerings.

b. Account for all expenses incurred to date that directly relate to the future nonregulated subsidiary.

c. Submit a plan for an accounting procedure for the interim expenses relating to the provision of enhanced services.

71. The record abundantly demonstrates there are substantial weaknesses in the costing methods used by Pacific to support its rate design proposals.

72. All parties concede that further refinements of the GE-100 costing method are necessary to develop reasonably acceptable costs for ratemaking purposes.

73. Further hearings should be held to review and determine equitable costing procedures.

74. Terminal equipment pricing policy should be reviewed by the Commission.

75. Sale of telephone terminal equipment to customers of Pacific is a desirable concept.

76. Parties to the proceeding should be ordered to file proposals by September 15, 1981 for the sale of terminal equipment to consumers.

77. Rates for each type of telephone service should cover the cost of that service.

78. Although the aim of the Commission is to establish rates based on costs so that all services and equipment bear rates reflecting their fair share of costs, it should be the Commission's policy that increases no greater than about 50% per year for any class of service is reasonable.

79. The increases in business and residence service basic exchange rates shown on Table 38 are reasonable.

80. Pending determination of any rate changes for private line and terminal equipment, it is reasonable to put a higher increase on business service exchange rates than for residence service.

81. Because of the rate increases we will authorize, it is fair and reasonable to waive the usual change of service charges so that customers will not be penalized when changing to the service that is the most economical for them.

82. Measured rate service represents the fairest distribution of costs among customers and should be the principal service for residence customers.

83. Elimination of the message allowance for one-party measured business service will result in more equitable charges for service actually used.

84. It is more costly to maintain and service semipublic coin telephones than regular telephones and there is no charge for the semipublic coin telephone instrument as there is for a regular instrument, therefore, it is fair to price semipublic coin telephone basic exchange rates considerably higher than other business services.

85. A reduction in the evening discount for ZUM service from 35% to 30% is reasonable because it will then match the discount for toll service.

86. Increases in units per minute for ZUM Zones 2 and 3 are reasonable.

87. All flat rate FEX services should eventually be converted to measured services.

88. Present resident FEX services should be frozen in exchanges where measured services are offered and no new FEX services are installed.

89. Flat rate residence FEX service should be frozen coincident with the introduction of measured residence services in areas where such services are not offered.

90. Pacific has not provided sufficient data to support cost-based rates and charges for FEX services.

91. Pacific should be ordered to provide a study of all FEX services as part of its next major rate case.

92. The staff's recommended rates for FEX service and service connections are reasonable and should be adopted.

93. Service functions related to the installation of a telephone should be charged to customers on the basis of each functional element performed.

94. Multi-element charges for telephone installations should:

a. Be cost-related.

b. Reflect the cost incurred by Pacific for that customer.

c. Encourage customer use of PhoneCenters.

d. Relate to the activities performed so they are understandable to the customer.

95. The staff's proposed charges for telephone installations are reasonable and will be adopted.

96. No final adjustment to complex business service installations should be made pending outcome of the further hearings on costing procedures.

97. There is a wide availability of FCC-approved telephone sets on the market, many selling for less than $25.

98. Pending the outcome of the further hearings on costing procedures, it is reasonable to adopt station set rates proposed by Pacific.

99. There is adequate justification to increase toll rates above the level proposed by Pacific or the staff.

100. It is fair to surcharge all rates not otherwise increased by this decision to make up the needed revenue requirement.

101. WATS should be increased proportionally to the toll rate increase and ORTS and OCMS by formulas used in previous proceedings.

102. Pacific should be directed to make a study and submit a proposal in six months for restructuring intrastate WATS similar to interstate WATS with rates that yield the same revenue then in effect.

103. The present discount resulting from Proposition 13 property tax reductions should be discontinued because the results of operations adopted reflect property taxes paid in the test year including Proposition 13 savings.

104. The staff's recommended residence modular conversion program is reasonable and should be adopted.

105. The staff's proposal for a 30¢ per month rate for maintenance of business inside wiring furnished by Pacific is reasonable and other recurring charges for business inside wiring should be discontinued because of the service connection charges authorized by this decision.

106. The staff's proposal for unbundling and restructuring business extension services so that all telephone sets of similar type are provided at the same rate is reasonable and should be adopted.

107. Pacific's proposed revised schedule for expanding residence service SMRT in lieu of that ordered in D.90642 and D.90919 is reasonable and will provide for the orderly expansion of SMRT.

108. Pacific should be ordered to make a study of implementing measured services for businesses in exchanges where 1MR and 1MQ services are offered, including an implementation schedule, the revenue requirement, and a proposed tariff, and present the study in its next major rate case and notify potentially affected customers of the proposed tariff.

109. Pacific, Continental, Citizens, and General should present exhibits and testimony in Pacific's next major rate case on the possibility of expanding ORTS service as recommended by the staff. Customers who might be affected should be notified prior to submission of the testimony and exhibits.

110. ZUM, which is now used in the San Francisco, East Bay, and Los Angeles extended areas, is a usage-sensitive pricing structure which provides the most equitable form of pricing to the user by incorporating the call measurement functions of frequency, time-of-day, duration, and distance.

111. The implementation of ZUM should be considered for the four additional areas of Orange County, San Diego, and Sacramento extended areas, and the Los Angeles Metropolitan exchanges of Pomona, Ontario, and Etiwanda.

112. Pacific, General, Roseville, and Citizens should present exhibits and testimony in Pacific's next rate case on the feasibility of expanding ZUM as noted in the previous finding. Customers who might be affected should be notified prior to submission of the testimony and exhibits.

113. The rates authorized Pacific in this proceeding will increase the revenues for all other telephone companies operating in California.

114. Except for General and Continental, the staff should be directed to monitor the earnings of the independents so that revenue increases resulting from this decision do not produce excessive earnings for the independents.

115. Because General is now before us with A.60340 for rate increases, we can determine the effects of increased settlements resulting from this decision and make appropriate adjustments to General's estimated results of operations in A.60340.

116. Because Continental was authorized an annual revenue increase based on a 1981 test year by D.92804 dated March 17, 1981, we will order Continental to establish a negative annual surcharge of $9,000,000 to reflect the increase in annual settlement revenues resulting from this decision.

117. The independents should be authorized to file revised FEX rates to reflect the pass-through of Pacific's increases authorized by this decision.

118. To the extent not covered by previous findings and pending further hearings and a decision on revisions to the costing procedures used for ratemaking purposes, the rate design discussed in this decision and the specific rates shown in Appendix F are reasonable and should be authorized.

119. The stipulation by Pacific and Allied described in this decision concerning mobile telephone service should be adopted.

120. Consideration of the staff's proposal concerning the maintenance by Pacific of separate records of legal and other departmental expenses relating to equal employment opportunity litigation should be deferred pending completion of C.10308.

121. The staff recommendations that Pacific make changes in its books of account for Chamber of Commerce dues and other donations and interest during construction and property taxes on land are not reasonable and should not be adopted.

122. Pacific has not shown bad faith in its efforts to retain eligibility for income tax benefits under the AAA/AA depreciation methods for ratemaking purposes.

123. The appropriateness of depreciation rates used by Pacific and approved by this Commission should be reviewed in further hearings.

124. Pacific's proposal for an allowance for attrition in the calendar year subsequent to the adopted test year is not reasonable and should not be adopted.

125. Because there is a need to put Pacific in a more secure financial position, the revenue increase granted by this decision will not be subject to refund even though there may be a realignment of rates as a result of further hearings. This should not apply to any reserve accumulated in connection with the AAA/AA treatment of accelerated depreciation.

126. Pacific should be ordered to provide the Commission within 60 days from the effective date of this decision a financing plan indicating proposed capital offerings for the two-year period October 1981 to October 1983.

127. The increases in rates and charges authorized by this decision are justified, and are just and reasonable.

128. Because there is an immediate need for the rate relief authorized, this decision should be made effective five days from today.

Conclusion of Law

Based on the foregoing findings of fact and under PU Code § 454 this Commission may grant Pacific authority to increase rates as provided in the following order to enable Pacific to earn additional annual revenues amounting to $610.1 million.

INTERIM ORDER

IT IS ORDERED that:

1. Pacific's request to reduce Western's net income for ratemaking purposes by the disallowed license contract product-related costs without reflecting such costs in the pricing of products is denied.

2. The revenue increase resulting from D.91495 as modified by D.92542 is no longer subject to refund except for any reserve accumulated in connection with the AAA/AA treatment of accelerated depreciation.

3. Pacific and the staff together with anv representatives of the burglar and fire alarm industry and any other parties who may wish to participate shall form a committee to:

a. Meet and confer to determine reasonable standards for the installation and repair of private line services used by the alarm industry.

b. Incorporate the determinations of Paragraph 3.a. into a proposed general order.

c. Present the proposed general order to the Commission within 120 days from the effective date of this decision.

4. Related to the FCC Computer Inquiry II decision Pacific shall file a report with this Commission by November 1, 1981 which:

a. Accounts for all expenses incurred to October 1, 1981 relating to existing and future enhanced service offerings.

b. Accounts for all expenses incurred to October 1, 1981 that relate directly to the future unregulated operations.

c. Includes a plan for accounting for the interim expenses relating to the provision of enhanced services.

5. Pacific is authorized to file with this Commission, 15 days after the effective date of this order, in conformity with the provision of General Order 96-A, revised tariff schedules with rates, charges, and conditions modified as set forth in Appendix F. The effective date of the revised tariff sheets shall be 5 days after the date of filing. The revised tariff schedules shall apply to service rendered on and after the effective date of the revised schedules.

6. Pacific shall waive its change of service charges for a period of 90 days after the effective date of tariffs filed under this order for customers of individual line flat-rate residence service who convert to measured rate service or party line service. Within 45 days after the effective date of this order Pacific shall notify individual line flat-rate residence service customers of the applicable rates for their service and alternative services and of the provision to waive the change of service charges for 90 days.

7. Pacific shall include as a part of its next major rate application cost studies which develop the costs associated with FEX access lines including central office costs, the line haul portion of FEX services and the costs associated with establishment of FEX services. These cost studies should be the basis for a proposed tariff to be included in Pacific's next major rate application along with the revenue effect of the proposed tariff.

8. Pacific is directed to make a study and file a proposed tariff, within 6 months after the effective date of this order, which changes the rate structure of its intrastate WATS to a structure parallel to that in effect for interstate WATS with no increase in net revenue.

9. Pacific shall include as a part of its next major rate application an alternative rate design including a proposed tariff revision covering the expansion of measured business services in exchanges where single message rate timing for residence services is or will be offered. In addition to a proposed tariff revision Pacific shall provide a study containing an implementation schedule and the revenue requirement associated with the expansion of measured business service. All customers who might be affected by the proposed tariff revisions shall be provided written notice that such a proposed tariff is being considered by the Commission.

10. Pacific, General, Continental, and Citizens shall submit, as a part of Pacific's next major rate application, testimony and exhibits which address the feasibility of implementing ORTS in all exchanges which presently receive "in" ORTS calls, the revenue requirement in terms of added plant and additional expenses associated with the expansion of ORTS over these additional routes, and the customer billing effects associated with implementing ORTS over the additional routes. Pacific, General, Continental, and Citizens shall also provide written notice to each of its customers who would be affected by the implementation of ORTS over the additional routes prior to submission of the testimony and exhibits.

11. Pacific, Roseville, General, and Citizens shall submit, as a part of Pacific's next major rate application, testimony and exhibits which address the feasibility of implementing ZUM service over the additional routes as set forth in Appendix O of Exhibit 242, the revenue requirement in terms of added plant and additional expenses associated with the expansion of ZUM over these additional routes, and

the customer billing effects associated with implementing ZUM over the additional routes. Pacific, General, Roseville, and Citizens shall also provide written notice to each of its customers who would be affected by the implementation of ZUM over the additional routes prior to submission of the testimony and exhibits.

12. Continental shall reduce its billing surcharge in the amount of $9,000,000 per year to reflect increased settlement revenues it will receive from intrastate toll service and extended area service by the rate increases granted.

13. On or after the effective date of this order, each respondent in OII 81 is authorized to file foreign exchange service tariffs consistent with the revised basic exchange rates of Pacific, as set forth in Appendix B of this order,and,concurrently, to cancel or modify its present tariffs to make them consistent. Such filing shall comply with General Order 96-A. The effective date of the revised schedules shall be 5 days after the date of filing.

14. The stipulation by Pacific and Allied concerning mobile telephone service is adopted.

15. Within 60 days from the effective date of this order, Pacific shall file with the Commission a financing plan indicating proposed capital offerings for the two-year period October 1981-October 1983.

16. A prehearing conference is scheduled for August 25, 1981 at 10:00 a.m. in San Francisco for the purpose of determining the nature of and times and places for further hearings in this proceeding on these subjects:

a. An appropriate method for allocating to the proper user any net stranded investment as a result of Pacific's migration strategy and the establishment of nonregulated operations on March 1, 1982, as required by the FCC Computer Inquiry II decision.

b. Capital costs and expenses of establishing the nonregulated operations by Pacific referred to in Ordering Paragraph 16.a.

c. Studies by Pacific and the staff to determine the kinds of equipment which may have been retired prior to being fully depreciated, the associated amount of undepreciated or stranded investment, and a method for recovering fairly any stranded investment.

d. A determination of equitable methods for developing cost of service studies for ratemaking such as the GE-100 method.

e. Sale of Pacific equipment to users.

f. Depreciation rates used for ratemaking.

17. Pacific shall place advertisements in newspapers of general circulation that detail the rate increases authorized by this decision at least 10 days prior to the effective date of the rates.

18. The rates authorized in this decision shall be subject to refund upon further order of the Commission only on any accumulated reserve in connection with the AAA/AA treatment of accelerated depreciation.

19. Pacific shall and the staff and any other parties to this proceeding who wish to do so may, by September 15, 1981, file proposals for the sale of equipment to consumers.

20. The staff shall monitor the earnings of the independent telephone companies to ensure that revenue increases resulting from this decision do not produce excessive earnings for the independents.

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

The effective date of this order is 5 days from today.

Dated AUG 4 1981, at San Francisco, California.

John E. Bryson
President

Commissioners

I concur;
See attached
Richard D. Gravelle

I Concur
See Attached

I concur:
See attached.
John E. Bryson

APPENDIX A
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## LIST OF APPEARANCES

Applicant: Walter J. Sleeth, Diane B. Prescott, Randall E. Cape, and Paul H. White, Attorneys at Law, for The Pacific Telephone and Telegraph Company.

Protestant: Richard S. Kopf and Jose E. Guzman, Jr., Attorneys at Law, for Southern Pacific Communications Company.

Interested Parties: Orrick, Herrington, Rowley & Sutcliffe, by James F. Crafts, Jr., and Robert J. Gloistein, Attorneys at Law, and Richard Pfeifer, for Continental Telephone Company of California; A. M. Hart, R. H. Snyder, Jr. and Kenneth K. Okel, Attorneys at Law, by Kenneth K. Okel, and Richard L. Ohlson, for General Telephone Company of California; Warren A. Palmer and Michael F. Willoughby, by Michael F. Willoughby, Attorney at Law, for Cal-Autofone, Radio Electronics Products Corp., Chalfont Communications, Industrial Communications, and Peninsula Radio Secretarial Service; Antone S. Bulich, Jr., and Allen Crown, Attorneys at Law, for California Farm Bureau Federation; William L. Knecht, Attorney at Law, for Telephone Users' League; Stanley Sackin and Morrison & Foerster, by James P. Bennett, Attorney at Law, for Telephone Answering Services of California, Inc.; Ann Murphy, Attorney at Law, for Toward Utility Rate Normalization (TURN); Graham and James, by Boris H. Lakusta, David J. Marchant, and Thomas J. MacBride, Attorneys at Law, for California Hotel and Motel Association; Virginia Bane, for Tel Rad, Inc.; Brobeck, Phleger & Harrison, by Gordon Davis, William H. Booth, and James M. Addams, Attorneys at Law, for California Retailers Association and Tele-Communications Association; McKenna, Wilkinson & Kittner, by Joseph M. Kittner and Norman P. Leventhal, for American Broadcasting Companies, Inc. and CBS, Inc.; Carl Hilliard, Attorney at Law, for Delphi; Virginia Lyons, for Lyons Answering Service; Robert W. Whitehead, for The Phone Exchange Answering Service; Joel A. Effron and Kathryn Beck, for California Interconnect Association; David A. Artson, for Artson Answering Service; John L. Mathews, Attorney at Law, for Executive Agencies of the United States; Allen B. Wagner, Attorney at Law, for

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The Regents of the University of California; Gold, Herscher, Marks & Pepper, by Lessing E. Gold, Attorney at Law, for Western Burglar & Fire Alarm Association; Dinkelspiel, Pelavin, Steefel & Levitt, by David M. Wilson, Attorney at Law, for Allied Telephone Companies Association; Ross J. Cadenasso, for California Association of Utility Shareholders; Burt Pines, City Attorney, by Ed Perez, Attorney at Law, for the City of Los Angeles; George Agnost, City Attorney, by Leonard L. Snaider, Attorney at Law, and Robert R. Laughead, P.E., for the City and County of San Francisco; John Witt, City Attorney, by William S. Shaffran, Deputy City Attorney, and Ronald L. Johnson, Attorney at Law, for the City of San Diego; Alberto Saldamando, Carmen Estrada, and Robert Gnaizda, Attorneys at Law, and Jose Guerrero, for Mexican-American Political Association, League of United Latin American Citizens, American G.I. Forum, IMAGE, and Los Padrinos; James Nelson, for County of Los Angeles, Department of Communications; Linda Hendrix McPharlin, Attorney at Law, and W. K. Edwards, for Sonitrol Telephone Assistance; William B. Hancock, for Cut Utility Rates Today (CURT); and Manuel Kroman, Sidney J. Webb, and Mel Hanberg, for themselves.

Commission Staff: Rufus G. Thayer, Jr., Attorney at Law, and R. M. Moeck, T. Lew, and J. Pretti.

(END OF APPENDIX A)

APPENDIX B
Page 1

The Pacific Telephone and Telegraph Company

MAJOR FORMAL RATE PROCEEDINGS

Years 1957-1980

| Appl. or Case No. | Description | Decision Number | Date Decided | Reference |
|---|---|---|---|---|
| A-39309 | The Company was granted an interim rate increase of $12,066,000 annually by Decision No. 55936. By final order, Decision No. 56652, an additional increase of $15,456,000 annually in rates was authorized. | 55936<br>56652 | 12-10-57<br>5- 6-58 | 56 CPUC 80<br>56 CPUC 277 |
| C-7409 | Commission investigation on its own motion into the rates, tolls, etc. of the Company. Interim Decision No. 67369 called for $40,722,000 annual reduction in revenues and retroactive refunds to customers of amounts collected from beginning of investigation, July 26, 1962. Decision No. 67498 denied rehearing. Decision No. 67499 stayed the order to reduce rates and to make refunds pending review by California Supreme Court, to which the Company has appealed. On April 28, 1965 the Supreme Court upheld the rate reduction but annulled the retroactive refunds prior to July 20, 1964. Decision No. 69069 lifted stay on interim order and made reduced rates effective as of July 20, 1964 and ordered the Company to file a plan for refunding amounts collected from customers on and after July 20, 1964. Final Decision No. 71575 maintained the net overall revenue reduction ordered in interim decision but rearranged the rate structure. | 67369<br>67498<br>67499<br>69069<br>71575 | 6-11-64<br>7-10-64<br>7-10-64<br>5-18-65<br>11-23-66 | 62 CPUC 775<br>63 CPUC 106<br>63 CPUC 117<br>64 CPUC 318<br>66 CPUC 419 |
| A-48643 | The Company was granted a rate increase of $6,100,000 annually. | 71350 | 10- 4-66 | 66 CPUC 248 |
| A-49142 | The Company was granted a rate increase of $50,200,000 annually. | 74917 | 11- 6-68 | 69 CPUC 53 |

APPENDIX B
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The Pacific Telephone and Telegraph Company

MAJOR FORMAL RATE PROCEEDINGS

Years 1957-1980

| Appl. or Case No. | Description | Decision Number | Date Decided | Reference |
|---|---|---|---|---|
| C-8858 | The Commission initiated an investigation into the treatment for rate making purposes of the Western Electric Co. prices and the California Corporation Franchise tax. | 76726 | 1-27-70 | 70 CPUC 644 |
| A-51774 | Decision No. 78851 granted the Company a rate increase of $143,000,000. Several parties appealed this decision. Upon reviewing the matter, the California Supreme Court annulled the Commission's decision and directed that all monies collected under that decision be refunded. Decision No. 80346 ordered the Company to make refunds. Decision No. 80347 reconsidered the Company's application in light of the Supreme Court's decision and granted the Company a rate increase of $55,400,000. | 78851<br>80346<br>80347 | 6-22-71<br>8- 5-72<br>8- 5-72 | 72 CPUC 327 |
| A-52794 | Decision No. 79873 granted the Company a $70,000,000 rate increase. The increase was reduced to $68,900,000 by Decision No. 79941. Decision No. 80348 reaffirmed the rate increase granted by Decision No. 79941. | 79873<br>79941<br>80348 | 4- 4-72<br>4-11-72<br>8- 5-72 | 73 CPUC 222<br>73 CPUC 331<br>73 CPUC 769 |
| A-53587 | Decision No. 83162 granted the Company a $183,300,000 rate increase. | 83162 | 7-23-74 | 77 CPUC 117 |
| A-55214 | Decision No. 85287 granted the Company a $65,200,000 rate increase. Decision No. 87827 reduced the rate increase by $7,500,000. | 85287<br>87827 | 12-30-75<br>9- 7-77 | 79 CPUC 240<br>82 CPUC 517 |
| A-55492 | Decision No. 88232 granted the Company a $12,800,000 rate increase. Decision No. 90362 reduced the rate increase by $5,817,000. | 88232<br>90362 | 12-13-77<br>6- 5-79 | |

APPENDIX B
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The Pacific Telephone and Telegraph Company

MAJOR FORMAL RATE PROCEEDINGS

Years 1957-1980

| Appl. or Case No. | Description | Decision Number | Date Decided | Reference |
|---|---|---|---|---|
| A-57465 | Decision No. 90842 granted the Company a $23,300,000 increase in directory advertising rates. | 90842 | 9-25-79 | |
| A-58223 | Decision No. 90642 reduced rates by $42,200,000. Following petitions for rehearing, Decision No. 90919 changed the amount from a rate reduction to a rate increase of $1,300,000 and granted rehearing to consider the effect on rate of return of higher debt and preferred stock costs. Decision No. 91121 granted $36,600,000 to offset these costs. Decision No. 91062 made the rates in Decision No. 90919 subject to refund pending consideration of a petition for rehearing by the cities of Los Angeles, San Diego, and San Francisco. Decision No. 91355 granted limited rehearing to determine whether the delay in implementation of the ZUM plan resulted in unsupported revenues flowing to Pacific. | 90642<br>90919<br>91062<br>91121<br>91355 | 7-31-79<br>10-10-79<br>11-20-79<br>12-18-80<br>2-13-80 | |
| A-53587 Remand | Decision No. 83162 was remanded to the Commission for consideration of alternative treatments of accelerated tax depreciation and investment tax credits. Decision No. 87838 ordered refunds of $205,586,000 through December 31, 1977 and rate reductions for 1978 of $60,494,000. The order was stayed pending appeal in state and federal courts. After the appeals were denied, the commission held hearings in 1979 on refund plans and motions to set future rates on normalization subject to refund pending determination of tax liability by federal courts. | | | |

APPENDIX B
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The Pacific Telephone and Telegraph Company

MAJOR FORMAL RATE PROCEEDINGS

Years 1957-1980

| Appl. or Case No. | Description | Decision Number | Date Decided | Reference |
|---|---|---|---|---|
| A-53587 Remand (continued) | Decision No. 91337 ordered refunds for the period from August 17, 1974 to February 13, 1980 and authorized rates after February 13, 1980 on a full normalization basis subject to refund. | 87838<br>91337 | 9-13-77<br>2-13-80 | 82 CPUC 549 |
| A-59269 OII 63 | Decision No. 91495 granted $227.2 million increase based on test year 1980 on interim basis. $30.1 of the $227.2 was rescinded by Decision No. 92542 on the bases of no showing and improper notice. | 91495<br>92542 | 4-2-80<br>12-16-80 | |

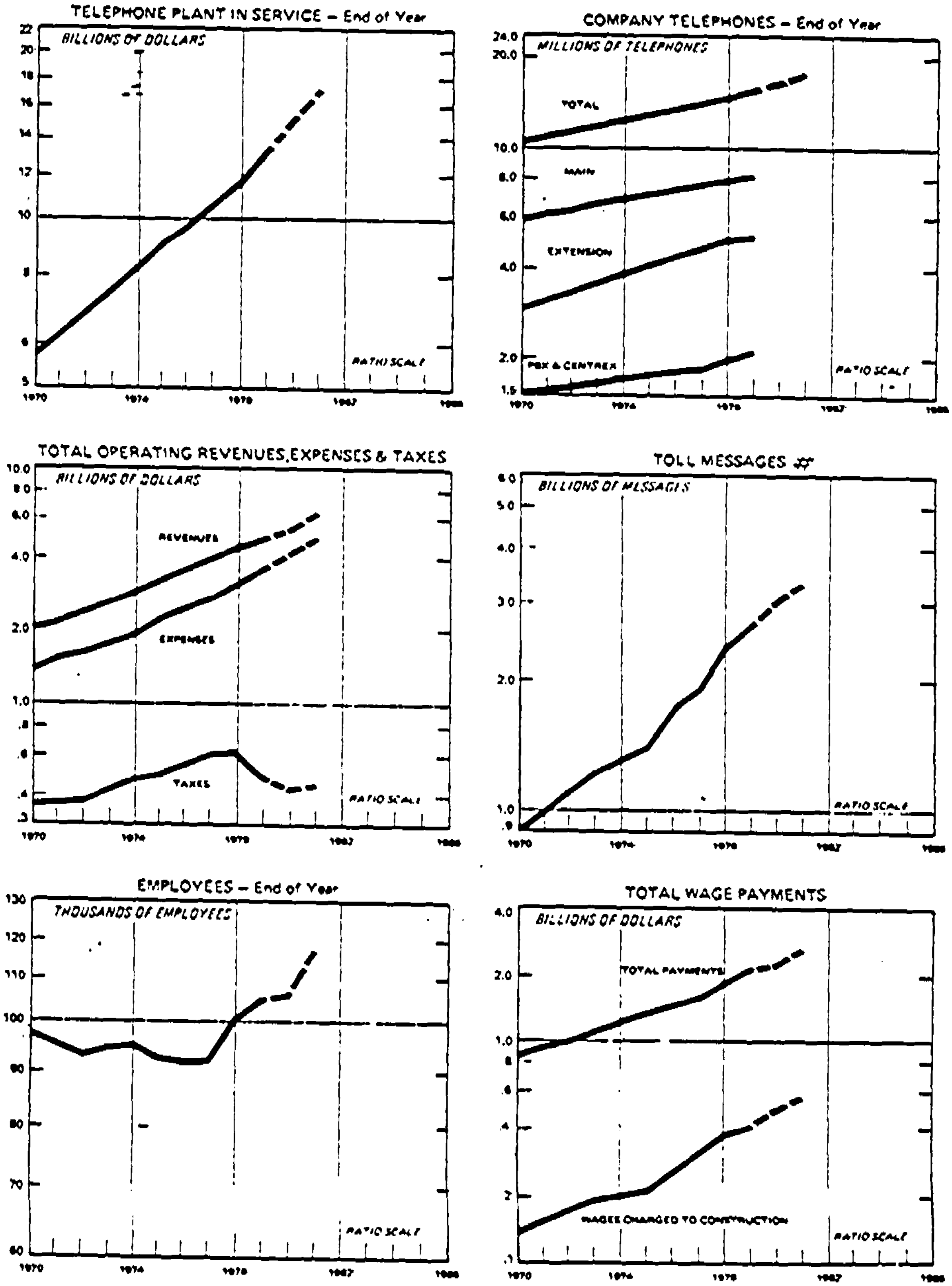
(END OF APPENDIX B)

A.59849 et al. /ALJ/bw THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY Chart 2-A

APPENDIX C

## GROWTH CURVES

### 1970-1981*




*Estimated 1980 and 1981. # Includes Independent Company Recorded Messages.

APPENDIX D
Page 1

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Results of Total California Operations
Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff |
|---|---|---|---|
| Operating Revenues | $ 6,380,016 | $ 6,544,368 | $ 164,352 |
| Operating Expenses & Taxes | | | |
| Current Maintenance | 1,569,530 | 1,705,134 | 135,604 |
| Depreciation & Amortization | 852,566 | 896,221 | 43,655 |
| Traffic Expenses | 406,256 | 417,822 | 11,566 |
| Commercial Expenses | 706,121 | 730,766 | 24,645 |
| Gen. Office Salaries & Expenses | 355,621 | 371,513 | 15,892 |
| Operating Rents | 51,889 | 54,412 | 2,523 |
| Gen. Services & Licenses | 55,515 | 88,355 | 32,840 |
| Balance Other Oper. Expenses | 567,628 | 669,116 | 101,488 |
| Total Oper. Expenses | 4,565,126 | 4,933,339 | 368,213 |
| Operating Taxes-Federal Income | 300,436 | 186,124 | (114,312) |
| Cal. Corp. Franch. | 52,198 | 65,635 | 13,437 |
| Social Security | 132,305 | 138,882 | 6,577 |
| Other | 130,488 | 136,897 | 6,409 |
| Total Expenses & Taxes | 5,180,553 | 5,460,877 | 280,324 |
| Net Revenues | 1,199,463 | 1,083,491 | (115,972) |
| Avg. Net Plant & Working Capital | | | |
| Telephone Plant-in-Service | 15,683,907 | 16,008,289 | 324,382 |
| Telephone Plant Under Constr. | | | |
| Property Held for Fut. Tel. Use | 2,910 | 2,910 | 0 |
| Telephone Plant Acquisition Adj. | | | |
| Working Cash Allowance | 228,165 | 303,178 | 75,013 |
| Material and Supplies | 130,678 | 149,946 | 19,268 |
| Less: Depreciation Reserve | 2,934,645 | 2,924,140 | (10,505) |
| Less: Reserve for Deferred Taxes | 1,485,707 | 1,495,377 | 9,670 |
| Total Rate Base | 11,625,308 | 12,044,806 | 419,498 |
| Rate of Return | 10.32% | 9.00% | (1.32)% |

(Red Figure)

APPENDIX D
Page 2

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Results of California Intrastate Operations
Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff |
|---|---|---|---|
| **Operating Revenues** | | | |
| Local Service Revenues | $2,375,863 | $2,452,050 | $ 76,187 |
| Toll Service Revenues | 2,079,818 | 2,130,704 | 50,886 |
| Miscellaneous Revenues | 339,800 | 323,646 | (16,154) |
| Uncollectibles | (51,177) | (62,042) | (10,865) |
| Total | 4,744,304 | 4,844,358 | 100,054 |
| **Operating Expenses & Taxes** | | | |
| Current Maintenance | 1,135,282 | 1,227,407 | 92,125 |
| Depreciation & Amortization | 639,510 | 672,897 | 33,387 |
| Traffic Expenses | 318,625 | 328,963 | 10,338 |
| Commercial Expenses | 582,375 | 607,042 | 24,667 |
| Gen. Office Salaries & Expenses | 278,569 | 287,844 | 9,275 |
| Operating Rents | 41,553 | 42,105 | 552 |
| Gen. Services & Licenses | 41,514 | 66,072 | 24,558 |
| Balance Other Oper. Expenses | 428,826 | 498,674 | 69,848 |
| Total Oper. Expenses | 3,466,254 | 3,731,004 | 264,750 |
| Operating Taxes-Federal Income | 192,087 | 111,850 | (80,237) |
| Cal. Corp. Franch. | 28,460 | 9,363 | (19,097) |
| Social Security | 100,065 | 103,507 | 3,442 |
| Other | 97,579 | 102,362 | 4,783 |
| Total Expenses & Taxes | 3,884,445 | 4,058,086 | 173,641 |
| **Net Revenues** | 859,859 | 786,272 | (73,587) |
| **Avg. Net Plant & Working Capital** | | | |
| Telephone Plant-in-Service | 11,728,426 | 11,987,458 | 259,032 |
| Telephone Plant Under Constr. | | | |
| Property Held for Fut. Tel. Use | 2,180 | 2,227 | 47 |
| Telephone Plant Acquisition Adj. | | | |
| Working Cash Allowance | 173,250 | 229,631 | 56,381 |
| Material and Supplies | 97,643 | 113,021 | 15,378 |
| Less: Depreciation Reserve | 2,206,853 | 2,164,230 | (42,623) |
| Less: Reserve for Deferred Taxes | 1,116,657 | 1,107,460 | (9,197) |
| Total Rate Base | 8,677,989 | 9,060,647 | 382,658 |
| **Rate of Return** | 9.91% | 8.68% | (1.23)% |

(Red Figure)

APPENDIX D
Page 3

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Total Operating Revenues - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| | Local Service Revenues | | | | |
| 500 | Subscriber Station Rev. | $2,123,199 | $2,191,950 | $ 68,751 | $2,123,200 |
| 501 | Public Telephone Rev. | 56,000 | 63,517 | 7,517 | 56,000 |
| 503 | Service Stations | 250 | 276 | 26 | 300 |
| 504 | Intra. Local PL & Other | 38,580 | 38,500 | (80) | 38,600 |
| 504 | Inter. Local PL & Other | 2,280 | 2,280 | 0 | 2,300 |
| | Subtotal | 2,220,309 | 2,296,523 | 76,214 | 2,220,400 |
| | Toll Service Revenues | | | | |
| | Intrastate Toll | 2,038,028 | 2,086,155 | 48,127 | 1,984,000 |
| | Interstate Toll | 1,643,806 | 1,722,079 | 78,273 | 1,643,800 |
| | Subtotal | 3,681,834 | 3,808,234 | 126,400 | 3,627,800 |
| | Miscellaneous Revenues | | | | |
| 523 | Directory Adv. & Sales | 289,200 | 280,480 | (8,720) | 289,200 |
| | Other Miscellaneous Revs. | 50,600 | 43,166 | (7,434) | 50,600 |
| | Subtotal | 339,800 | 323,646 | (16,154) | 339,800 |
| | Total Before Uncollectibles | 6,241,943 | 6,428,403 | 186,460 | 6,188,000 |
| 530 | Uncollectible Revenues | (75,304) | (85,148) | (9,844) | (74,500) |
| | Total Before Adjustments | 6,166,639 | 6,343,255 | 176,616 | 6,113,500 |
| | Marketing & Competition | (9,300) | (9,300) | 0 | (9,300) |
| | D. 91495 (Incl. Adv. Ltr. 13641) | 243,065 | 243,065 | 0 | 243,100 |
| | FCC Decision ID No. 80-297 | 28,375 | 0 | (28,375) | 28,400 |
| | Traffic Expense Adj. | 80 | 0 | (80) | 100 |
| | Adjusted Oper. Revs. | 6,428,859 | 6,577,020 | 148,161 | 6,375,800 |
| | Tran. to Long Line Adj. | (16,191) | 0 | 16,191 | (16,200) |
| | Rescinded Advice Ltr. 13641 | (32,652) | (32,652) | 0 | (32,700) |
| | Recast Operating Revs. | 6,380,016 | 6,544,368 | 164,352 | 6,326,900 |

(Red Figure)

APPENDIX D
Page 4

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Maintenance Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 602 | Repairs of Outside Plant | $ 262,300 | $ 262,300 | $ 0 | $ 262,300 |
| 603 | Test Desk Work | 250,853 | 250,853 | 0 | 250,900 |
| 604 | Repairs of Central Ofc. Equip. | 513,657 | 567,195 | 53,538 | 516,300 |
| 605 | Repairs of Station Equip. | 458,599 | 513,949 | 55,350 | 488,500 |
| 606 | Repairs of Bldgs. & Grounds | 55,088 | 56,499 | 1,411 | 55,100 |
| 610 | Maintaining Transmission Power | 31,711 | 26,043 | (5,668) | 33,900 |
| 612 | Oth. Maintenance Expense | 29,658 | 29,658 | 0 | 29,700 |
| | Subtotal Before Adjs. | 1,601,866 | 1,706,497 | 104,631 | 1,636,700 |
| | Electrical Energy Adj. | (4,400) | 0 | 4,400 | (4,400) |
| | Reduction of Construction Exp. | (3,806) | 0 | 3,806 | (3,800) |
| | Allocation of Adm. Bldgs. | (46) | (46) | 0 | - |
| | Subtotal Adjustments | (8,252) | (46) | 8,206 | (8,200) |
| | Total Maintenance Expense | 1,593,614 | 1,706,451 | 112,837 | 1,628,500 |
| | Deprec. SL-RL Adjustment | (845) | (1,317) | (472) | (800) |
| | Adjusted Maintenance Exps. | 1,592,769 | 1,705,134 | 112,365 | 1,627,700 |
| | Affiliated Int. Adj. | (14,837) | 0 | 14,837 | (7,600) |
| | Tran. to Long Line | (17,748) | 0 | 17,748 | (17,700) |
| | Wage Contract Adj. | 9,346 | 0 | (9,346) | 9,300 |
| | Recast Maintenance Exps. | 1,569,530 | 1,705,134 | 135,604 | 1,611,700 |

(Red Figure)

APPENDIX D
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THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Depreciation Expense
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Depreciation Expense | $859,923 | $897,927 | $38,004 | $859,900 |
| Allocation to Nevada | (21) | (21) | 0 | - |
| IDC Rate Adjustment | (307) | (307) | 0 | (300) |
| IDC Short-Term CWIP Adj. | 2,459 | 2,459 | 0 | 2,500 |
| Total Deprec. Exp. | 862,054 | 900,058 | 38,004 | 862,100 |
| Remaining Life Adj. to Other Operating Expenses | | | | |
| a. Maintenance Exp. | (845) | (1,317) | (472) | |
| b. Traffic Expense | (16) | (24) | (8) | |
| c. Commercial Exp. | (78) | (122) | (44) | |
| d. Bal. Oth. Exp. | (62) | (97) | (35) | |
| e. Total (a. to d.) | (1,001) | (1,560) | (559) | 1,000 |
| Total Adj. Depreciation Exp. | 861,053 | 898,498 | 37,445 | 861,100 |
| Reversal of Cl. Acc. Amts. (Reassign to proper accts.) | 1,001 | 1,560 | 559 | 1,000 |
| Affiliated Int. Adj. | (9,488) | (3,837) | 5,651 | (9,200) |
| Recast Depreciation Exp. | 852,566 | 896,221 | 43,655 | 852,900 |
| Adjustments: Modernization | | | | 400 |
| | | | | 853,300 |

(Red Figure)

APPENDIX D
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THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Traffic Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 621 | Genl. Traffic Supervision | $ 47,179 | $ 48,342 | $ 1,163 | $ 47,200 |
| 622 | Serv. Inspec. & Cust. Instr. | 9,219 | 9,219 | 0 | 9,200 |
| 624 | Operators Wages | 283,007 | 296,848 | 13,841 | 283,300 |
| 626 | Rest and Lunchrooms | 926 | 980 | 54 | 900 |
| 627 | Operators Employment & Train. | 13,974 | 14,536 | 562 | 14,000 |
| 629 | C.O. Stationery and Printing | 9,593 | 9,753 | 160 | 9,600 |
| 630 | C.O. House Services | 3,245 | 3,380 | 135 | 3,200 |
| 631 | Misc. Traffic Ofc. Exps. | 34,831 | 35,563 | 732 | 34,800 |
| 632 | Public Telephone Exps. | 200 | 413 | 213 | 200 |
| 635 | Joint Traffic Expenses-CR. | (453) | (453) | 0 | (500) |
| | Subtotal Before Adjs. | 401,721 | 418,581 | 16,860 | 401,900 |
| | Decision 91495 Adj. | (735) | (735) | 0 | (700) |
| | Total Traffic Exps. | 400,986 | 417,846 | 16,860 | 401,200 |
| | Deprec. S.L.- R.L. Adj. | (16) | (24) | (8) | - |
| | Adjusted Traffic Expenses | 400,970 | 417,822 | 16,852 | 401,200 |
| | Tran. to Long Line | (2,406) | 0 | 2,406 | (2,400) |
| | Wage Contract Adj. | 7,692 | 0 | (7,692) | 7,700 |
| | Recast Traffic Exps. | 406,256 | 417,822 | 11,566 | 406,500 |

(Red Figure)

APPENDIX D
Page 7

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Commercial Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 640 | Genl. Commercial Admin. | $107,519 | $116,106 | $ 8,587 | $107,700 |
| 642 | Advertising | 24,000 | 27,873 | 3,873 | 24,000 |
| 643 | Sales Expense | 82,524 | 86,641 | 4,117 | 82,500 |
| 644 | Connecting Co. Relations | 1,059 | 1,136 | 77 | 1,100 |
| 645 | Loc. Commercial Opers. | 332,367 | 342,939 | 10,572 | 335,400 |
| 648 | Public Telephone Comms. | 22,055 | 22,751 | 696 | 22,100 |
| 649 | Directory Expenses | 136,328 | 136,345 | 17 | 136,300 |
| 650 | Other Commercial Exps. | 50 | 50 | 0 | 100 |
| | Subtotal Before Adjs. | 705,902 | 733,841 | 27,939 | 709,200 |
| | Prior Advertising Disallowances | (2,876) | (2,846) | 30 | (2,900) |
| | Open Line Advertising Adj. | (500) | 0 | 500 | (1,000) |
| | Multistate Marketing Adj. | (5,718) | 0 | 5,718 | (5,700) |
| | Subtotal Adjustments | (9,094) | (2,846) | 6,248 | (9,600) |
| | Total Commercial Expenses | 696,808 | 730,995 | 34,187 | 699,600 |
| | Dues and Donations Adj. | (107) | (107) | 0 | (100) |
| | Deprec. S.L.-R.L. Adj. | (78) | (122) | (44) | (100) |
| | Adjusted Commercial Exps. | 696,623 | 730,766 | 34,143 | 699,400 |
| | Wage Contract Adj. | 9,498 | 0 | (9,498) | 9,500 |
| | Recast Commercial Exps. | 706,121 | 730,766 | 24,645 | 708,900 |

(Red Figure)

APPENDIX D
Page 8

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted General Office Salaries and Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 661 | Executive Department | $ 1,872 | $ 1,902 | $ 30 | $ 1,900 |
| 662 | Accounting Department | 173,215 | 187,004 | 13,789 | 181,000 |
| 663 | Treasury Department | 9,226 | 9,226 | 0 | 9,200 |
| 664 | Law Department | 8,447 | 8,447 | 0 | 8,400 |
| 665 | Other Genl. Ofc. | 165,857 | 165,857 | 0 | 165,900 |
| | Subtotal Before Adjs. | 358,617 | 372,436 | 13,819 | 366,400 |
| | Citizenship Activities | (124) | (124) | 0 | |
| | Legislative Advocacy | (521) | (521) | 0 | |
| | Shareholder Visits | (382) | (382) | 0 | |
| | Antitrust Activities | (378) | 0 | 378 | |
| | Subtotal Adjs. | (1,405) | (1,027) | 378 | (1,400) |
| | Total Genl. Ofc. Exps. | 357,212 | 371,409 | 14,197 | 365,000 |
| | Reassign Adjs. to Proper Accts. | | | | |
| | a. Dues & Donations | (117) | (117) | 0 | |
| | Reverse Overhead Loading for: | | | | |
| | b. Citizenship Activities ) | | 27 | 0 | |
| | c. Legislative Advocacy ) | 221 | 107 | 0 | |
| | d. Shareholder Visits ) | | 87 | 0 | |
| | e. Subtotal Adjs. | 104 | 104 | 0 | 100 |
| | Adjusted Genl. Ofc. Exps. | 357,316 | 371,513 | 14,197 | 365,100 |
| | Wage Contract Adj. | (1,695) | 0 | 1,695 | (1,700) |
| | Recast Genl. Ofc. Exps. | 355,621 | 371,513 | 15,892 | 363,400 |

(Red Figure)

APPENDIX D
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THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Other Operating Expenses
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| 668 | Insurance | $ 960 | $ 960 | $ 0 | $ 1,000 |
| 669 | Accident & Damage | 2,405 | 2,405 | 0 | 2,400 |
| 671 | Operating Rents | 51,889 | 54,412 | 2,523 | 51,900 |
| 672 | Relief & Pensions | 559,669 | 630,202 | 70,533 | 630,200 |
| 674 | Genl. Service & Licenses | 55,515 | 88,355 | 32,840 | 57,500 |
| 675 | Other Expenses | 62,435 | 64,093 | 1,658 | 62,400 |
| 677 | Expense Charged to Const. | (32,629) | (34,433) | (1,804) | (32,600) |
| | Subtotal Before Adjs. | 700,244 | 805,994 | 105,750 | 772,800 |
| | Exclusion of Dues & Donations | (738) | (647) | 91 | (700) |
| | Relief and Pensions | 419 | 419 | 0 | 400 |
| | Decision 91495 (Incl. Advice Ltr. 13641) | 7,463 | 7,463 | 0 | 7,500 |
| | Pioneer Activities | (195) | 0 | 195 | - |
| | Subtotal Adjustments | 6,949 | 7,235 | 286 | 7,200 |
| | Total Other Oper. Expenses | 707,193 | 813,229 | 106,036 | 780,000 |
| | Reformat - Reassign adjs. to proper accts. | | | | |
| | a. Dues & Donations (Commercial Exp.) | 107 | 107 | 0 | |
| | b. Dues & Donations (G.O. Sal. Exp.) | 117 | 117 | 0 | |
| | c. Depr. S.L.-R.L. (Bal. Oth.) | (62) | (97) | (35) | |
| | d. Pen. & Payroll (Bal. Oth. Overhead Loading) | (221) | (215) | | |
| | e. Dues & Donations (Gen. Ofc. Overhead Loading) | 6<br>38 | 38 | 0 | |
| | f. Subtotal | (15) | (50) | (35) | - |
| | Traffic Exp. Adj. | 44 | 0 | 44 | - |
| | Tran. to Long Line | (3,781) | 0 | 3,781 | (3,800) |
| | Wage Contract Adj. | (27,113) | 0 | 27,113 | (27,100) |
| | Rescinded-Advice Ltr. 13641 | (1,296) | (1,296) | 0 | (1,300) |
| | Recast Other Oper. Exps. | 675,032 | 811,883 | 136,851 | 747,800 |

(Red Figure)

APPENDIX D
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THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Taxes Other Than Income
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| Ac. | | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|---|
| | Operating Taxes | | | | |
| 307.1 | Ad Valorem Taxes | $124,486 | $130,895 | $ 6,409 | |
| 307.2 | State Gross Receipts | 892 | 892 | 0 | |
| 307.4 | Other State & Local Taxes | 5,105 | 5,105 | 0 | |
| | Subtotal | 130,483 | 136,892 | 6,409 | |
| | Payroll Taxes | | | | |
| 307.5 | Calif. Unemployment Insur. | 11,300 | 11,858 | 558 | |
| 307.6 | Fed. Unemployment Insur. | 3,955 | 4,151 | 196 | |
| 307.7 | Fed. Insur. Contribution Act | 116,922 | 122,916 | 5,994 | |
| | Subtotal | 132,177 | 138,925 | 6,748 | |
| | Subtotal Before Adjs. | 262,660 | 275,817 | 13,157 | |
| | IDC and Taxes on Land | 6 | 6 | 0 | |
| | Total Taxes Oth. than Income | 262,666 | 275,823 | 13,157 | |
| | Pension & Payroll Taxes Adj. | | | | |
| | Payroll | (43) | (43) | 0 | |
| | Other | (1) | (1) | 0 | |
| | Adjusted Total Taxes Other Than Income | 262,622 | 275,779 | 13,157 | |
| | Tran. to Long Line | (1,057) | 0 | 1,057 | |
| | Wage Contract Adj. | 1,216 | 0 | (1,216) | |
| | Traffic Exp. Adj. | 12 | 0 | (12) | |
| | Recast Total Taxes Other Than Income | 262,793 | 275,779 | 12,986 | $262,800 |
| | Adjust for Adopted Expenses | | | | 700 |
| | Total Adopted Expenses | | | | 263,500 |

(Red Figure)

APPENDIX D
Page 11

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated Rate Base - Present Rates - 1981
(Dollars in Thousands)

Total Operations

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Telephone Plant-in-Service | $15,683,907 | $16,008,289 | $324,382 | $15,708,700 |
| Telephone Plant Under Constr. | | | | |
| Property Held for Fut. Tel. Use | 2,910 | 2,910 | 0 | 2,900 |
| Telephone Plant Acquisition Adj. | | | | |
| Working Cash Allowance | 228,165 | 303,178 | 75,013 | 170,000 |
| Materials and Supplies | 130,678 | 149,946 | 19,268 | 133,700 |
| Less: Depreciation Reserve | 2,934,645 | 2,924,140 | (10,505) | 2,935,900 |
| Less: Reserve for Deferred Taxes | 1,485,707 | 1,495,377 | 9,670 | 1,489,600 |
| Total Rate Base | 11,625,308 | 12,044,806 | 419,498 | 11,589,800 |

California Intrastate

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Telephone Plant-in-Service | $11,728,426 | $11,987,458 | $259,032 | 11,747,000 |
| Telephone Plant Under Constr. | | | | |
| Property Held for Fut. Tel. Use | 2,180 | 2,227 | 47 | 2,200 |
| Telephone Plant Acquisition Adj. | | | | |
| Working Cash Allowance | 173,250 | 229,631 | 56,381 | 129,100 |
| Materials and Supplies | 97,643 | 113,021 | 15,378 | 99,900 |
| Less: Depreciation Reserve | 2,206,853 | 2,164,230 | (42,623) | 2,207,800 |
| Less: Reserve for Deferred Taxes | 1,116,657 | 1,107,460 | (9,197) | 1,119,600 |
| Total Rate Base | 8,677,989 | 9,060,647 | 382,658 | 8,650,800 |

(Red Figure)

APPENDIX D
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THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Telephone Plant-In-Service
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Beginning-of-Year Balances | $14,910,300 | $15,014,626 | $104,326 | |
| Weighted Avg. Net Adds. | 897,100 | 1,019,762 | 122,662 | |
| Total Weighted Avg. Tel. Plant-in-Service | 15,807,400 | 16,034,388 | 226,988 | |
| Allocation to Nevada | (1,092) | (1,092) | 0 | |
| Plant Verification | (2,016) | (2,016) | 0 | |
| IDC Rate Adj. | (8,395) | (8,395) | 0 | |
| IDC on Short-Term Jobs | 67,164 | 67,164 | 0 | |
| IDC on Taxes on Land | (1,147) | (1,147) | 0 | |
| Subtotal Adjs. | 54,514 | 54,514 | 0 | |
| Total Tel. Plant-in-Service | 15,861,914 | 16,088,902 | 226,988 | $15,861,900 |
| Affiliated Int. Adj. | (178,007) | (80,613) | 97,394 | (173,100) |
| Recast Tel. Plant-in-Service | 15,683,907 | 16,008,289 | 324,382 | 15,688,800 |
| Adjustment - Modernization | | | | 15,800 |
| Adjustment - IDC Interest Rate | | | | 4,100 |
| Adopted Plant | | | | 15,708,700 |

(Red Figure)

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Property Held for Future Use
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Prop. Held for Future Use | $ 358 | $ 358 | $ 0 | - |
| IDC and Taxes on Land Adj. | 2,552 | 2,552 | 0 | |
| Recast Prop. Held for Fut. Use | 2,910 | 2,910 | 0 | $2,900 |

APPENDIX D
Page 13

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Materials and Supplies
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Materials and Supplies | $134,052 | $150,614 | $16,562 | $134,100 |
| Circuit-Paks Adj. | (2,652) | (668) | 1,984 | |
| Adjusted Materials and Supp. | 131,400 | 149,946 | 18,546 | |
| Affiliated Int. Adj. | (722) | 0 | 722 | (400) |
| Recost Materials and Supp. | 130,678 | 149,946 | 19,268 | 133,700 |

(Red Figure)

APPENDIX D
Page 14

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Estimated and Adopted Depreciation Reserve and Deferred Tax Reserve
Total Operations - Test Year 1981 - Present Rates
(Dollars in Thousands)

| | Staff | Pacific | Pacific Exceeds Staff | Adopted |
|---|---|---|---|---|
| Begin. of Yr. Deprec. Reserve | $2,855,895 | $2,836,560 | $(19,335) | |
| Deprec. Expense | 859,923 | 897,927 | 38,004 | |
| Deprec. Clearing Accounts | 16,832 | 15,811 | (1,021) | |
| Retirements | (616,900) | (666,000) | (49,100) | |
| Gross Salvage | 55,521 | 59,940 | 4,419 | |
| Cost of Removal | (86,366) | (93,240) | (6,874) | |
| Other | 600 | 600 | 0 | |
| End-of-Yr. Deprec. Reserve | 3,085,505 | 3,051,598 | (33,907) | |
| Net Additions to Reserve | (229,610) | (215,038) | 14,572 | |
| Weighted Adds. to Reserve | 117,335 | 105,094 | (12,241) | |
| Weighted Avg. Deprec. Reserve | 2,973,230 | 2,941,654 | (31,576) | |
| Allocation to Nevada | (133) | (133) | 0 | |
| IDC Rate Adjustment | (876) | (876) | 0 | |
| IDC Short-Term CWIP Adj. | 2,084 | 2,084 | 0 | |
| Total Avg. Deprec. Reserve | 2,974,305 | 2,942,729 | (31,576) | $2,974,300 |
| Affiliated Int. Adj. | (39,660) | (18,589) | 21,071 | (38,600) |
| Recast Deprec. Reserve | 2,934,645 | 2,924,140 | (10,505) | 2,935,700 |
| Adjustment for: Modernization | | | | 200 |
| Adopted Deprec. Reserve | | | | 2,935,900 |
| Normalized Tax Reserve | 1,485,707 | 1,495,377 | 9,670 | 1,485,700 |
| Adjust for Modernization | | | | 3,900 |
| Adopted Norm. Tax Reserve | | | | 1,489,600 |

(Red Figure)

APPENDIX D
Page 15

The Pacific Telephone and Telegraph Company
(Dollars in Thousands)

Adopted Estimated Results of Operations - 1981

| | Total Company Unadjusted | Intrastate Unadjusted | Intrastate Adjustments | Adjusted |
|---|---|---|---|---|
| Operating Revenues | $ 6,326,900 | $ 4,691,000 | $ 3,400 | $ 4,694,500 |
| **Operating Expenses & Taxes** | | | | |
| Current Maintenance | 1,611,700 | 1,160,100 | - | 1,160,100 |
| Depreciation & Amortization | 853,300 | 640,000 | - | 640,000 |
| Traffic Expenses | 406,500 | 319,100 | - | 319,100 |
| Commercial Expenses | 708,900 | 585,300 | - | 585,300 |
| Gen. Office Salaries & Exp. | 363,400 | 285,300 | (500) | 284,800 |
| Operating Rents | 51,700 | 41,600 | - | 41,600 |
| Gen. Services & Licenses | 57,500 | 43,000 | - | 43,000 |
| Balance Other Oper. Exp. | 638,400 | 481,200 | - | 481,200 |
| Total Oper. Expenses | 4,691,600 | 3,555,600 | (500) | 3,555,100 |
| Operating Taxes - Fed. Income | 223,200 | 131,400 | 1,600 | 133,000 |
| Cal. Corp. Franch. | 33,900 | 13,100 | 500 | 13,600 |
| Social Security | 133,000 | 100,200 | - | 100,200 |
| Other | 130,500 | 97,600 | - | 97,600 |
| Total Expenses & Taxes | 5,212,200 | 3,897,900 | 1,600 | 3,899,500 |
| Net Revenues | 1,114,700 | 793,200 | 1,800 | 795,000 |
| **Avg. Net Plant & Working Capital** | | | | |
| Telephone Plant-in-Service | 15,708,700 | 11,747,000 | - | 11,747,000 |
| Telephone Plant Under Constr. | - | - | - | - |
| Prop. Held for Fut. Tel. Use | 2,900 | 2,200 | - | 2,200 |
| Tel. Plant Acquisition Adj. | - | - | - | - |
| Working Cash | 170,000 | 129,100 | (800) | 128,300 |
| Material and Supplies | 133,700 | 99,900 | - | 99,900 |
| Less: Depreciation Reserve | 2,935,900 | 2,207,800 | - | 2,207,800 |
| Less: Reserve for Deferred Taxes | 1,489,600 | 1,119,600 | - | 1,119,600 |
| Total Rate Base | 11,589,800 | 8,650,800 | (800) | 8,650,000 |
| Rate of Return | 9.62% | 9.17% | - | 9.19% |

(Red Figure)

(END OF APPENDIX D)

# APPENDIX E

## Definitions of Main Telephones and Equivalent Main Telephones

### Main Telephones

These are telephones that are connected by individual, auxiliary, or party-line circuits directly to a central office switchboard or toll board. Connection may be by wire, radio channels, or power line carrier channels. Only one main telephone is reported for each individual line or subscriber on a party line. Main telephones are furnished dial tone by a central office and have seven- or ten-digit numbers assigned. Additional telephones connected to the same line are classified as "extensions" and are not counted.

### Equivalent Main Telephones

These are central office lines that terminate in other than a main telephone. They are services requiring a seven- or ten-digit number or an equivalent that has not been reported as a main telephone. These include the following: access lines to teletypewriters; business answering lines; lines and trunks that connect primary centrex telephones, centrex consoles, or centrex switching equipment; Wide Area Telephone Service (WATS) access lines that connect directly to the direct distance dialing network; lines or trunks to PBX system; foreign exchange lines; auxiliary lines to the same telephone; marine jacks that may be connected to public and semipublic coin telephones etc.; or any other service requiring central office line switching equipment, not reported elsewhere as main telephone or equivalent main telephone. The equipment can be telephone company-owned or customer-owned but it must be able to use the regular exchange facilities and direct distance dial network.

### Main plus Equivalent Main Telephones

These are main telephones plus equivalent main telephones as broadly defined above. They are essentially circuits that terminate in a central office and would require or generate maintenance work for central office plant personnel. Main plus equivalent main telephones have a high correlation with time required for maintenance of central offices and are therefore used as a load indicator by AT&T. Main plus equivalent main telephones are roughly equal to total telephones less extensions.

(END OF APPENDIX E)

APPENDIX F
Page 1
RATES AND CHARGES

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

Basic Exchange Access Rates

Schedules Cal. P.U.C. Nos. 4-T and 13-T, Individual Line and Private Branch Exchange Trunk Lines Services

The following revisions are authorized:

| | Monthly Rate |
|---|---|
| Residence Flat Rate Individual Line Service | |
| Exchanges Outside Metropolitan Areas | $ 6.70* |
| Metropolitan Extended Areas | |
| Los Angeles and San Francisco-East Bay | 7.00 |
| Orange County, Sacramento and San Diego | 6.70 |
| Residence Flat Rate PBX Trunk Service | 1½ times Residence Flat Individual Line Rate |
| Business Measured Rate Individual Line Service and Measured PBX Trunk Line Service | |
| Exchanges Outside Metropolitan Areas | 7.00*-0 |
| Metropolitan Extended Areas | |
| Los Angeles, Orange County, Sacramento San Diego and San Francisco - East Bay | 7.00*-0 |
| Semipublic Coin | |
| All Exchanges | 13.00* |

*Plus present EAS or other rate increments where applicable.

Schedule Cal. P.U.C. No. 117-T, Airport Intercommunicating Service

The following revisions are authorized:

| | |
|---|---|
| Airport Intercommunicating Service | |
| Business Individual Line Service: | |
| Primary Station Line - | |
| On Airport Property | $15.25 -0 |
| Off Airport Property | 23.25 -0 |
| Commercial Manual PBX Service: | |
| Trunk Line | 15.25 -0 |
| Mechanized Station Service: | |
| Trunking: | |
| First 25 Mechanized Primary Station Lines | 17.50 |
| Each Additional Mechanized Primary Station Line | .70 |

Schedule Cal. P.U.C. No. 121-T, Centrex Service

The following revisions are authorized:

| | |
|---|---|
| Centrex Service | |
| Exchange Access Trunking Charge | |
| Measured Rate Service | |
| ESS, #5XB-First 100 Primary Lines or Less | $70.00 |
| Each Additional Primary Line | .70 |
| #101ESS,701 - First 100 Primary Lines or Less | 70.00 |
| Each Additional Primary Line | .70 |

APPENDIX F
Page 2

RATES AND CHARGES

Zone Usage Measurement Service

Schedule Cal. P.U.C. No. 6-T, Zone Usage Measurement Service

The following revisions are authorized:

| Zone | Initial Period 1-Minute or Portion Thereof | Each Additional Minute or Portion Thereof |
|---|---|---|
| 1 (Local) | 3 units | 1 units |
| 2 (9-12 Miles) | 6 " | 3 " |
| 3 (13-16 Miles) | 8 " | 5 " |

Zone Calling Unit Rate Discounts apply as follows:

| | Monday | Tuesday | Wednesday | Thursday | Friday | Saturday | Sunday |
|---|---|---|---|---|---|---|---|
| 8:00 AM To 5:00 PM | | | DAY FULL | RATE PERIOD RATE | | | |
| 5:00 PM To 11:00 PM | | | EVENING 30% | RATE PERIOD DISCOUNT | | | |
| 11:00 PM To 8:00 AM | | | NIGHT 60% | RATE PERIOD DISCOUNT | | | |

Foreign Exchange Service

Schedule Cal. P.U.C. No. 34-T, Foreign Exchange Service

The following revisions are authorized:

| | |
|---|---|
| Business | |
| Individual Line Message Rate | $15.50* |
| PBX Trunk, First, Message Rate | 15.50* |
| PBX Trunk, Each Additional, Message Rate | 15.50* |
| Residence | |
| Residence Flat Rate Individual Line Service | |
| Exchanges Outside Metropolitan Areas | 8.20# |
| Metropolitan Extended Areas | |
| Los Angeles and San Francisco-East Bay | 8.50 |
| Orange County, Sacramento and San Diego | 8.20 |

*No message or monthly allowance.
#Plus EAS increments were applicable.

The offering of residence individual line flat rate foreign exchange service from those foreign exchanges which offer residence individual line measured rate service is limited to existing customers. Customers with residence individual line flat rate foreign exchange service may continue with the flat rate service until disconnection. All applicants for new service from foreign exchanges with residence measured rate exchange service will be furnished residence measured rate foreign exchange service.

APPENDIX F
Page 3

RATES AND CHARGES

Service Connection Charges

Schedule Cal. P.U.C. No. 28-T, Multi-Element Service Charges

The following revisions are authorized:

APPLICABILITY

Multi-element service charges apply to simple individual and party-line residence and business exchange service and facilities, except where otherwise indicated.

CHARGES

| | USOC | Charge Res. | Charge Bus. |
|---|---|---|---|
| (1) Elements for new and additional service, move and changes and in place connections | | | |
| (a) Service Establishment, Additions, Moves, Changes and Record Work | | | |
| 1. Service Establishment For establishing new, in place or additional service (i.e. central office lines) | *M1 | $10.00 | $21.00 |
| 2. Additions, Moves and Changes For moving or changing existing service and equipment or adding new or additional service and equipment other than central office lines | *M2 | 9.00 | 12.50 |
| 3. Record Work For record work and billing additions and changes only | *M3 | 6.00 | 12.50 |
| (b) Central Office Connection Work, each line | | | |
| 1. Primary Service | | | |
| a. Local and Extended Area Service (Local Charge) | *M4 | 13.00 | 13.75 |
| b. Foreign Prefix Service in same exchange or district area (FXS Charge) | | 52.00# | 52.00# |
| c. Foreign Exchange or Foreign District Area Service with or without Foreign Prefix Service | | | |
| Contiguous (FXS Charge) | | 52.00# | 52.00# |
| Noncontiguous (FXS Charge) | | 99.00# | 99.00# |

#For individual access line, trunk line, TAS trunk line and answering line services furnished as complex foreign exchange, foreign district area or foreign prefix services charges of $38.25 and $85.25 in addition to the applicable charges shown in Section I of Schedule Cal. P.U.C. No. 28-T will apply for such services furnished on a contiguous and noncontiguous basis respectively.

RATES AND CHARGES

Multi-Element Service Charges - Continued

| | | USOC | Charge Res. | Charge Bus. |
|---|---|---|---|---|
| (1) | Elements for new and additional service, move and changes and in place connections - Continued | | | |
| | (c) Premises Visit Charge | *M9 | $ 6.25 | $ 7.75 |
| | (d) Premises Interior Wiring Work Per connecting point | *M5 | 16.75 | 21.50 |
| ØØ | (e) Station Handling Work Per telephone or other terminal equipment | *M6 | 4.00 | 10.00 |
| | (f) Jack Charge | Ø | Ø | Ø |

A Utility-provided jack is required for use with each Utility or authorized customer-provided telephone or equipment and a Utility or an authorized customer-provided station is required with each central office line.

For exchange services other than simple individual and party line residence and business services, see Sections I., II. and III. of this schedule, except where otherwise indicated.

Ø Refer to Schedule Cal. P.U.C. No. 135-T for modular jacks and interface arrangements.

ØØ Not applicable to authorized customer-provided telephone.

## RATES AND CHARGES

Multi-Element Service Charges - Continued

Application of Multi-Element Service Charges

| New and Additional Service | Charge Elements Per: | Order | | | Line | Visit | IW | Sta |
|---|---|---|---|---|---|---|---|---|
| | USOC: | *M1 | *M2 | *M3 | *M4 | *M9 | *M5 | *M6 |
| | Res: | $10. | 9. | 6. | 12. | 6.25 | 16.75 | 4. |
| | Bus: | $21. | 12.50 | 12.50 | 13.75 | 7.75 | 21.50 | 10. |
| Simple Service | | | | | | | | |
| New or additional individual access line | | | | | | | | |
| With Premises Visit: | | | | | | | | |
| with Utility telephone | | x | - | - | øx | x | x | x |
| with authorized C-P telephone | | x | - | - | øx | x | x | - |
| Without Premises Visit | | | | | | | | |
| with Utility or authorized C-P telephone | | x | - | - | øx | - | - | - |
| New or additional party line service (Utility telephone only) | | | | | | | | |
| With Premises Visit | | x | - | - | øx | x | x | x |
| Without Premises visit | | x | - | - | øx | - | - | - |
| In place connection of individual or party line service including all in place stations and supplemental equipment, no changes | | x | - | - | øx | Z | - | - |
| New or additional Farmer Line Service | | x | - | - | Local per line x | - | - | - |

A Utility-provided jack is required for use with each Utility or authorized customer-provided telephone or equipment and a Utility or an authorized customer-provided station is required with each central office line.

ø For Foreign Exchange, Foreign Prefix or Foreign District Area Services, use FXS charge instead of Local charge for each line.
Z Applicable only when a premises visit is necessary

APPENDIX F
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## RATES AND CHARGES

Multi-Element Service Charges-Continued

Application of Multi-Element Service Charges

| New and Additional Service - Continued | Per: | Order | | | Line | Visit | IW | Sta |
|---|---|---|---|---|---|---|---|---|
| | USOC: | *M1 | *M2 | *M3 | *M4 | *M9 | *M5 | *M6 |
| | Res: | $10. | 9. | 6. | 13. | 6.25 | 16.75 | 4. |
| | Bus: | $21. | 12.50 | 12.50 | 13.75 | 7.75 | 21.50 | 10. |
| Simple Service - Continued | | | | | | | | |
| ¢Extension Service | | | | | | | | |
| Same exchange or district area | | | | | | | | |
| Continuous property | | | | | | | | |
| -With Utility telephone | | - | x | - | - | x | x | x |
| -With authorized C-P telephone | | - | x | - | - | x | x | - |
| Noncontinuous property | | | | | | | | |
| -With Utility telephone | | - | x | - | x | x | x | x |
| -With authorized C-P telephone | | - | x | - | x | x | x | - |
| Foreign exchange or Foreign District area | | | | | | | | |
| -With Utility telephone | | - | x | - | x | x | x | x |
| -With authorized C-P telephone | | - | x | - | x | x | x | - |
| Additional station, same extension line, same premises, same order | | - | - | - | - | - | x | x |
| Additional station, same extension line, same premises subsequent order | | - | x | - | - | x | x | x |
| Complex Service | | | | | Local per line | | | |
| New or additional Farmer Line Service | | x | - | - | x | - | - | - |

¢ No Multi-Element charges are applicable to only add an authorized C-P set to the records.

RATES AND CHARGES

Multi-Element Service Charges-Continued

Application of Multi-Element Service Charges

| Subsequent Moves and Changes | | Charge Elements | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Per: | Order | | | Line | Visit | IW | Sta |
| | USOC: | *M1 | *M2 | *M3 | *M4 | *M9 | *M5 | *M6 |
| | Res: | $10. | 9. | 6. | 13. | 6.25 | 16.75 | 4. |
| | Bus: | $21. | 12.50 | 12.50 | 13.75 | 7.75 | 21.50 | 10. |
| Simple Service | | | | | | | | |
| Change between FXS and local primary service (includes change of telephone number) | | x | - | - | Per ϕLine | - | - | - |
| Change of set to Design Line, each | | Residence $32.00, Business $41.75 | | | | | | |
| Consolidate or deconsolidate billing, each IN order | | - | - | x | - | - | - | - |
| Complex Service | | | | | | | | |
| Consolidate or deconsolidate billing, each IN order | | - | - | x | - | - | - | - |

ϕ Each "IN" line for FXS or local service

## RATES AND CHARGES

**Multi-Element Service Charges-Continued**

**Special Conditions**

Multi-element service charges include five basic elements:

Service Establishment, Additions, Moves, Changes and Record Work.

These charges apply for customer requested work which is performed by the Utility. It includes the receiving, recording and processing of the customer requests for service to be completed on the same date in connection with each primary service.

Service Establishment Charge

Service Establishment Charge applies to one or more new, in place and additional service (line) on the same service order, supersedure of residence and business service, and reconnection of business service as set forth in this schedule.

Additions, Moves and Changes Charge

Except as otherwise shown, the Additions, Moves and Changes charge applies to each service order issued for customer requested additions, moves or changes of service and equipment on an existing customer account.

Record Work Charge

The Record Work Charge applies when a customer requests a record or billing addition or change which requires a service order to be issued on the customer account without additions or changes in equipment or facilities.

Note:

Except as otherwise shown, the Service Establishment, Additions, Moves Changes and Record Work charges apply on a per service order issued basis. Where applicable, more than one addition or change can be made on the same service order without additional service order charge. Where more than one charge is applicable, the higher charge applies.

RATES AND CHARGES

Schedule Cal. P.U.C. No. 28-T, Residence Modular Conversion Program

The following revisions are ordered:

Modular Conversion Provisions For Residence Services

A. Inward Service Orders
Only modular telephones and modular jacks will be installed on inward service orders. In addition up to four additional existing nonmodular locations will be converted to modular at no charge to the customer. Multi-element charges will apply to customer requested new modular locations and to the conversion of more than four existing nonmodular locations.

B. Outward Service Orders
All locations where instruments are removed on outward service orders will be converted to modular and up to four additional existing nonmodular locations, at the discretion of the utility, may also be converted to modular on outward service orders.

C. Repair Visits
Defective telephone sets will be replaced with modular telephone sets and the connecting point for the replaced telephone sets will be converted to modular. No other modular conversions will be made unless requested by the customer in which case multi-element charges will apply to such customer requested conversions except as set forth herein.

D. Existing Nonmodular Residence Connections

1. The utility will provide written notice of the provisions shown under D. herein by bill insert to all existing customers three times at equal 8-month intervals beginning with the first month after the effective date of this order.

2. For a period of 24 months after the effective date of this order, the utility will waive the service order charge (*M2), premises visit charge (*M9), station handling charges (*M6) and charges for standard modular jacks when an existing customer requests modular conversion of a residence premises where the customer is provided with simple residence service.

3. The utility will, upon request by an existing customer, convert to modular all nonmodular sets and locations where utility-provided nonmodular sets are presently connected and convert to modular up to four existing nonmodular connection arrangements. Multi-Element charges will be applicable to customer requested conversions in excess of these limits.

4. After the expiration of the waiver of charges as set forth in D2 above, all customer requested modular conversions will be provided at the applicable multi-element and modular jack charges then in effect.

RATES AND CHARGES

Modular Conversion Provisions For Residence Services - Continued

5. The waiver of charges set forth in D.2. above will not be applicable for residence premises which have heretofore been converted to modular under A. and/or B. above.

6. Customer requests for additional services (excluding additional central office lines and central office services) on the same service order for modular conversion may be provided at the same time as the modular conversion. The waiver of the service order charge as set forth in D.2. above will apply. The additional services will be provided on the same order at the applicable rates and charges for such services.

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RATES AND CHARGES

Station Sets

Schedules Cal. P.U.C. Nos. 4-T, 32-T, 34-T and 80-T, Station Sets

The following revisions are authorized:

| Each Extension Service | Monthly Rates Business & Residence Flat | Meas. |
|---|---|---|
| Individual Access Line | | |
| *Extension Telephone With Rotary dial | $1.00 | $1.00 |
| With Touch-Tone dial | 1.55 | 1.55 |
| Two-party line service | | |
| *Extension Telephone With Rotary dial | 1.00 | 1.00 |
| With Touch-Tone dial | 1.55 | 1.55 |
| Suburban Service | | |
| *Extension Telephone With Rotary dial only | 1.00 | - |

* Provided in addition to the charges and rates applicable to the interior wiring.

RATES AND CHARGES

**Station Sets - Continued**

Primary Station Sets

Individual Access Lines and Primary Station Services

| | Monthly Rates |
|---|---|
| Individual Access Lines | |
| *Rate for a Utility-provided primary station set, excluding Princess and Trimline types. | |
| Rotary dial telephone set | $1.00 |
| Touch-Tone dial telephone set | 1.55 |
| Primary Station Services | |
| #Individual line semipublic service, including a Utility-provided primary station set | |
| Rotary dial telephone set | No additional charge |
| Touch-Tone dial telephone set | $ .55 |
| #Two-party line and suburban services - rate for a Utility-provided primary station set, excluding Princess and Trimline types. | |
| Rotary dial telephone set | No additional charge |
| Touch-Tone dial telephone set, suburban Services excluded | $ .55 |

* The above rates are in addition to the charges and rates for the access line of the class, type and grade ordered.

\# Individual line semipublic, two-party line and suburban services include a rotary station in the primary station rate.

RATES AND CHARGES

**Station Sets - Continued**

Special Type Telephone Sets

| | Monthly Rate |
|---|---|
| Each Princess telephone set: | |
| Equipped with rotary dial | $2.10* |
| Equipped with Touch-Tone dial | 2.90* |
| Each Trimline telephone set: | |
| Equipped with rotary dial | 2.50* |
| Equipped with Touch-Tone dial | 3.25* |

* The above rates are in addition to the charges and rates for access line of the class, type and grade ordered, or to the extension service, PBX or Centrex line furnished to a customer.

RATES AND CHARGES

Message Toll Telephone Service

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

The following revisions are authorized:

| | Initial Period Station (Sent Paid) | | Each Additional Minute |
|---|---|---|---|
| | DIAL ø | COIN + | ALL CLASSES OF SERVICE |
| RATE MILEAGE | 1-Minute DAY RATE | 3-Minute ALL DAYS/HOURS | Day Rate |
| 0- 8 | $0.14 | $0.25 | $0.06 |
| 9- 12 | .14 | .25 | .06 |
| 13- 16 | .16 | .35 | .08 |
| 17- 20 | .20 | .45 | .12 |
| 21- 25 | .23 | .55 | .14 |
| 26- 30 | .26 | .65 | .17 |
| 31- 40 | .29 | .80 | .20 |
| 41- 50 | .33 | .95 | .24 |
| 51- 70 | .37 | 1.05 | .28 |
| 71- 90 | .41 | 1.20 | .32 |
| 91-110 | .44 | 1.30 | .34 |
| 111-130 | .47 | 1.40 | .36 |
| 131-150 | .50 | 1.50 | .38 |
| 151-170 | .53 | 1.60 | .40 |
| 171-195 | .56 | 1.75 | .42 |
| 196-220 | .58 | 1.85 | .43 |
| 221-245 | .60 | 2.00 | .44 |
| Over 245 | .62 | 2.15 | .45 |

ø Operator Assisted Messages:

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

Station $ .75
Person $2.00

Customer Dialed Credit Card:

In addition to the DIAL computed charge a surcharge of $.40 is applicable per message for customer dialed credit card messages.

Note: Where facilities are capable of providing for placement of customer dialed credit card messages and the customer requests such a call to be placed by the operator, the Operator Assisted Surcharge of $.75 will apply.

\+ Coin Messages:

On Person messages paid for at a coin box, add $2.00 to the charges computed on a Station basis.

CONFERENCE SERVICE:

Rates and Special Conditions applicable to conference service are revised to the extent necessary by the changes authorized herein for two-point service.

RATES AND CHARGES

Wide Area Telephone Service

Schedule Cal. P.U.C. No. 128-T, Wide Area Telephone Service

The following revisions are authorized:

| | First 10 Hours Monthly Rate | First 100 Hours Monthly Rate | Each Add'l Hour |
|---|---|---|---|
| OUTWARD WATS | | | |
| Option #1 - 10 Hour | | | |
| Region | $210.00 | | $16.00 |
| State | 265.00 | | 21.00 |
| Option #2 - 100 Hour | | | |
| Region | | $800.00 | 8.00 |
| State | | 1,000.00 | 10.00 |
| 800 SERVICE (Inward WATS) | | | |
| Option #1 - 10 Hour | | | |
| Region | 265.00 | | 21.00 |
| State | 340.00 | | 28.00 |
| Option #2 - 100 Hour | | | |
| Region | | 900.00 | 10.00 |
| State | | 1,200.00 | 13.00 |

RATES AND CHARGES

Optional Residence Telephone Service

Schedule Cal. P.U.C. No. 131-T, Optional Residence Telephone Service

The following revisions are authorized:

1. Option 1 - Community Calling Plan

| Service Area Rate Group | Service Offerings Rate Mileage | Charge per Community: Each Exchange or District Area | Allowance per Community | Message Rate 1 Minute-Day | Message Rate Each Addl. Minute Day |
|---|---|---|---|---|---|
| 1 | 9-12 | $ 3.50 | $ 6.90 | $.070* | $.030* |
| 2 | 13-16 | 4.00 | 9.20 | .080 | .040 |
| 3 | 17-20 | 5.00 | 13.80 | .100 | .060 |
| 4 | 21-25 | 5.75 | 16.10 | .115 | .070 |
| 5 | 26-30 | 6.50 | 19.55 | .130 | .085 |
| 6 | 31-40 | 7.25 | 23.00 | .145 | .100 |

| Service Area Rate Group | Charges for Additional Allowance per Community: Double | Charges for Additional Allowance per Community: Triple @ | Additional Allowances: Double | Additional Allowances: Triple |
|---|---|---|---|---|
| 1 | $ 7.00 | $10.50 | $13.80 | $20.70 |
| 2 | 8.00 | 12.00 | 18.40 | 27.60 |
| 3 | 10.00 | 15.00 | 27.60 | 41.40 |
| 4 | 11.50 | 17.25 | 32.20 | 48.30 |
| 5 | 13.00 | 19.50 | 39.10 | 58.65 |
| 6 | 14.50 | 21.75 | 46.00 | 69.00 |

@ Maximum allowance
* $.06 on ZUM Routes
** $.05 on ZUM Routes

RATES AND CHARGES

Optional Residence Telephone Service - Continued

2. Option 2 - Circle Calling Plan

| Monthly Charge | Usage Allowance |
|---|---|
| $4.50 | $3.00 |

| Service Area Rate Group | Message Rate Minute-Day | Message Rate Each Additional Minute-Day |
|---|---|---|
| 1 | $.070* | $.030 |
| 2 | .080 | .040** |
| 3 | .100 | .060 |
| 4 | .115 | .070 |
| 5 | .130 | .085 |
| 6 | .145 | .100 |

* $.06 on ZUM Routes

** $.05 on Zum Routes

# RATES AND CHARGES

## Optional Calling Measured Service

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

The following revisions are authorized:

| Service Area Rate Group | Service Offerings Rate Mileage | Rate Per Service: Each Exchange or District Area Selected — Monthly Time Allowance * One Hour | Two Hours | Three Hours | Overtime Rate Per Minute Over Allowance * |
|---|---|---|---|---|---|
| I | 9-12 | $2.10 | $4.20 | $ 6.30 | $.06 |
| II | 13-16 | 2.40 | 4.80 | 7.20 | .08 |
| III | 17-20 | 3.00 | 6.00 | 9.00 | .12 |
| IV | 21-25 | 3.45 | 6.90 | 10.35 | .14 |
| V | 26-30 | 3.90 | 7.80 | 11.70 | .17 |
| VI | 31-40 | 4.35 | 8.70 | 13.05 | .20 |

* Applies between 8:00 a.m. and 8:00 p.m. Monday through Friday only. Calling between 8:00 p.m. and 8:00 a.m. daily and all day Saturday and Sunday is unlimited.

RATES AND CHARGES

<u>Billing Surcharge</u>
<u>Schedule Cal. P.U.C. No. 36-T, Rule No. 33</u>

**The following revisions are authorized:**

The present Rule No. 33 shall be withdrawn. The following shall be filed as Rul- No. 33:

Rule No. 33
Billing Surcharges

A billing reduction factor of 0% applies to the recurring rates for:

4-T Individual and Party Line Service
9-T Farmer Line Service
13-T Trunk Lines
34-T Trunk Lines, Individual Line, Party Line and Farmer Line Services
100-T Trunk Lines and Individual Business Lines
112-T Trunk Lines
117-T Trunk Lines and Individual Lines
121-T Trunk Lines and Dormitory Lines
125-T Trunk Lines

The billing reduction factor applies to each customer's bill for the total recurring rates for the listed services exclusive of federal and local excise taxes.

RATES AND CHARGES

Business Interior Wiring and Extensions

Schedule Cal. P.U.C. No. 4-T Individual and Party Line Service

The following revisions are ordered:

| Each Extension Service | Monthly Rate: Business Flat | Business Meas. | Residence Flat | Residence Meas. |
|---|---|---|---|---|
| Individual Access Line | | | | |
| With telephone, each service requires an EXT and TEL ++: | | | | |
| Interior Wiring | $.30 | $.30 | - | - |
| Without telephone In connection with: | | | | |
| Utility-provided equipment | .30 | .30 | - | - |
| Each authorized customer-provided telephone set or equipment | .30 | .30 | - | - |
| Two-party line service | | | | |
| Extension service: | | | | |
| Interior Wiring | .30 | - | - | - |
| Suburban Service | | | | |
| Extension Service: | | | | |
| Interior Wiring | .30 | - | - | - |

Schedule Cal. P.U.C. No. 12-T, Private Branch Exchange Service

The following revisions are ordered:

Commercial, Hotel and Residence Manual PBX Service

| Station Rates | Monthly Rates: Flat Rate | Measured Rate |
|---|---|---|
| Each Commercial or Hotel Station | | |
| Line or extension line with a station | | |
| With rotary dial | $1.00 | $1.00 |
| With Touch-tone dial | 1.55 | 1.55 |
| Interior Wiring for Station or extension line, each | .30 | .30 |
| Line without a station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided equipment | .30 | .30 |
| Extension line without a station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided equipment | .30 | .30 |

RATES AND CHARGES

Business Interior Wiring and Extensions-Continued

Commerical, Hotel and Residence Manual PBX Service-Continued

| | Monthly Rate Flat Rate | Monthly Rate Measured Rate |
|---|---|---|
| Each Residence Station | | |
| Line or extension line with a station | | |
| With rotary dial | $1.00 | Not offered |
| With Touch-Tone dial | 1.55 | " |
| Miscellaneous services without stations | | |
| Lines for automatic call distributing systems, each | .30 | $ .30 |
| Paging system connecting equipment line | .30 | .30 |
| Series Dial PBX Service | | |
| Station Rates - Dial-Series 100 and 300 | | |
| Each Commerical or Hotel Station | | |
| Series 100 | | |
| Line or extension line with station | | |
| With rotary dial | 1.00 | 1.00 |
| With Touch-Tone dial | 1.55 | 1.55 |
| Interior wiring for station or extension line, each | .30 | .30 |
| Line without a station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided instrument or key equipment | .30 | .30 |
| Extension line without station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided equipment | .30 | .30 |
| Series 300 | | |
| Line or extension line with station | | |
| With rotary dial | 1.00 | 1.00 |
| With Touch-Tone dial | 1.55 | 1.55 |
| Interior wiring for station or extension line, each | .30 | .30 |
| Line without a station | | |
| Terminating in Utility provided equipment | .30 | .30 |
| Terminating in customer-provided instrument or key equipment | .30 | .30 |
| Extension line without station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided equipment | .30 | .30 |

RATES AND CHARGES

Business Interior Wiring and Extensions-Continued

Series Dial PBX Service

| | Monthly Rate | |
|---|---|---|
| | Flat Rate | Measured Rate |
| Miscellaneous services without stations | | |
| Lines for automatic call distributing systems, each | $ .30 | $ .30 |
| Paging system connecting equipment line | .30 | .30 |
| Supplemental Services | | |
| Dial-Series 100 and 300 | | |
| Miscellaneous trunks between dial switching equipment and attendant position: | | |
| Each supplemental trunk from dial switching equipment to attendant position | .30 | .30 |
| Each intercepting trunk associated with exchange and toll message diverting equipment between dial switching equipment and attendant position | .30 | .30 |
| Each vacant level trunk between dial switching equipment and attendant position | .30 | .30 |

Modular Dial PBX Service - Class A

| | Flat Rate | Measured Rate |
|---|---|---|
| Supplemental attendant trunk from common equipment to console | .30 | .30 |

RATES AND CHARGES

Business Interior Wiring and Extensions-Continued

Dial PBX Service

| PBX Stations | Monthly Rate Flat Rate | Monthly Rate Measured Rate |
|---|---|---|
| Each Commercial or Hotel station | | |
| Line or extension line with station | | |
| With rotary dial | $1.00 | $1.00 |
| With Touch-Tone dial | 1.55 | 1.55 |
| Interior wiring for station or extension line, each | .30 | .30 |
| Line without a station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided instrument or key equipment | .30 | .30 |
| Extension line without a station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided equipment | .30 | .30 |
| Each Manual Commercial or Hotel Station | | |
| Line or extension line with station | | |
| With rotary dial | 1.00 | 1.00 |
| With Touch-Tone dial | 1.55 | 1.55 |
| Interior wiring for station or extension line, each | .30 | .30 |
| Line without a station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided equipment | .30 | .30 |
| Extension line without station | | |
| Terminating in Utility-provided equipment | .30 | .30 |
| Terminating in customer-provided equipment | .30 | .30 |
| Miscellaneous services without stations | | |
| Lines for automatic call distributing systems, each | .30 | .30 |
| Paging system connecting equipment line | .30 | .30 |
| Supplemental trunk between dial switching equipment and attendant position | .30 | .30 |

RATES AND CHARGES

Business Interior Wiring and Extensions-Continued

Schedule-Cal. P.U.C. No. 100-T, Telephone Answering Service

The following revisions are ordered:

Secretarial Line Service

| | Monthly Rate Business | |
|---|---|---|
| Each secretarial line extension of a customer's primary service terminated on cord operated equipment or key equipment located | Flat Rate | Message Rate |
| Within the same building | | |
| Individual or Two-party Line | $.30 | $.30 |
| Trunk Line | .30 | .30 |
| PBX Station | .30 | .30 |
| Centrex Primary Station | .30 | .30 |
| Airport Intercommunicating Service Mechanized Primary Station | - | 1.45 |
| Night Service Equipment Line | .30 | .30 |
| Each secretarial line extension of an: | | |
| Individual or Two-party Line | .30 | .30 |
| Each secretarial line extension of a: | | |
| PBX Trunk Line | .30 | .30 |
| Centrex-Central Office Location Primary Station | .30 | .30 |
| Night Connected Listed Directory Number of a Centrex-Central Office location | .30 | .30 |
| Airport Intercommunication Service Trunk Line | - | 1.45 |

Schedule Cal. P.U.C. No. 112-T, Mechanized Switching System Service

The following revisons are ordered:

| Lines, Stations and Associated Equipment Rotary Service only | Monthly Rate |
|---|---|
| Line with station | $4.50 |
| Line without station | 3.30 |
| Line with customer-provided instrument or key equipment | 3.30 |
| Extension line with station | 4.50 |
| Extension line without station | 3.30 |
| Extension line terminating in customer-provided equipment | 3.30 |

RATES AND CHARGES

Business Interior Wiring and Extensions-Continued

Schedule Cal. P.U.C. No. 117-T, Airport Intercommunicating Service

The following revisions are ordered:

| | Monthly Rate |
|---|---|
| Individual Line and PBX Service | |
| Business Individual Line Service | |
| Each extension station line with station | |
| With rotary dial | $2.65 |
| With Touch-Tone dial | 3.25 |
| Each extension station line without station | |
| Terminating in Utility-provided equipment | 1.45 |
| Terminating in customer-provided equipment | 1.45 |
| PBX Service | |
| Stations | |
| Line or extension line with station | |
| With rotary dial | 2.65 |
| With Touch-Tone dial | 3.25 |
| Line without station | |
| Terminating in Utility-provided equipment | 1.45 |
| Terminating in customer-provided equipment | 1.45 |
| Extension line without station | |
| Terminating in Utility-provided equipment | 1.45 |
| Terminating in customer-provided equipment | 1.45 |
| Mechanized station service | |
| Attendant equipment | |
| Attendant intercepting arrangement: | |
| Each attendant intercepting trunk | .30 |
| Stations | |
| Each mechanized primary line with station: | |
| With Rotary Dial | 11.95 |
| With Touch-Tone Dial | 12.55 |
| Each mechanized primary line without station: | |
| Terminating in Utility-provided equipment | 10.75 |
| Terminating in customer-provided equipment | 10.75 |
| Each extension line without station: | |
| With Rotary Dial | 7.45 |
| With Touch-Tone Dial | 8.05 |
| Each extension line without station: | |
| Terminating in Utility-provided equipment | 6.50 |
| Terminating in customer-provided equipment | 6.50 |
| Each primary partially restricted line with station: | |
| With Rotary Dial | 11.95 |
| With Touch-Tone Dial | 12.55 |

RATES AND CHARGES

Business Interior Wiring and Extensions - Continued

Schedule Cal. P.U.C. No. 121-T, Centrex Service

The following revisions are ordered:

| | Monthly Rate |
|---|---|
| Centrex Service | |
| Station and Lines (ESS; #5XB) | |
| Extension Lines | |
| Central Office Location (ESS; #5XB) Each, line | $0.30 |
| Dormitory - Each line | 0.30 |

Schedule Cal. P.U.C. No. 155-T, Automatic Call Distributing Service

The following revisions are ordered:

Automatic Call Distributing Service

Customer Premises Automatic Call Distributing Systems

| | Monthly Rate |
|---|---|
| Lines | |
| Each inward PBX station line to common equipment | $0.30 |
| Each line between attendant's turret equipment or attendant's position equipment and private branch exchange | .30 |
| Each transfer equipment to: | |
| Telephone set | 1.50 |
| Terminate on: | |
| Utility-provided equipment | .30 |
| Customer-provided instrument or key equipment | .30 |
| Private branch exchange system | .30 |
| AIS or Centrex attendant equipment | .30 |
| Each night service equipment line | .30 |

RATES AND CHARGES

Expansion of Single Message Rate Timing for Residence Services

The following revisions are authorized:

**Northern Sector**

1980

Michigan Bar
Shingle Springs
Paradise
Cottonwood
Blairsden
Petaluma
Sebastapol
Atwater
Clovis
Vacaville
Sonoma
Calistoga

1981

Woodland
Newman
Carrisa Plains
La Grange

1982

Cayucos
Grass Valley
Yountville
Dunnigan
Sonora
Pismo Beach

1983

Live Oak
Wheatland
North Yuba
Meridian
No. San Juan
Mt. Shasta
Loyalton
Healdsburg
Tomales
Lower Lake
Willets
Kelseyville

1983

Middletown
Boonville
Hopland
Jamestown
Chowchilla
Escalon
Hughson
Gustine
Sanford
Stratford
San Luis Obispo
Santa Margarita
Tracy
Pine Crest

1984

Gridley
Homewood
Georgetown
Yreka
Vina
St. Helena
Winters
Guerneville
Annapolis
Ft. Bragg
Upper Lake
Potter Valley
Merced
Porterville
Tulare
Selma
Del Rey
Arvin

**Bay Sector**

Now

Aptos
Watsonville
Carmel
Hercules/Pinole/Rodeo
San Martin

1981

Half Moon Bay

1982

East Contra Costa
Ignacio
La Honda

1983

Antioch
Boulder Creek
Castroville
Greenfield
Hollister
Pittsburg
Stinson Beach/Bolinas
Soledad

1984

Gonzales
Inverness
Nicasio
Point Reyes Stn.

**Southern Sector**

Now

Calexico
Del Mar
Encinitas
Fallbrook

1983

Rancho Santa Fe

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RATES AND CHARGES

There shall be applied to each rate element, recurring and non recurring, in the following tariff schedules, except as noted below, a uniform percentage surcharge which will yield $59.4 million of annual revenues at the 1981 level of business:

| Sched. No. | NAME |
|---|---|
| 12-T | Exchange Telephone Service - Private Branch Exchange Service: All items except station rates shown in Appendix F Pages 20 through 23. |
| 13-T | Exchange Telephone Service - Private Branch Exchange Trunk Line Service: Identified Outward Dialing Service and Direct Inward Dialing Service. |
| 22-T | Exchange Telephone Service - Key Equipment Service: All items. |
| 24-T | Exchange Telephone Service - Dispatching Telephone System Service: All items. |
| 26-T | Exchange Telephone Service - Mileage Rates: All items. |
| 28-T | Exchange Telephone Service - Service Connection Charges - Move and Change Charges - In Place Connection Charges - Multi-Element Service Charges: All items except Section IV Multi-Element Service Charges. |
| 32-T | Exchange Telephone Service - Supplemental Equipment: All items except Princess and Trimline Sets. |
| 34-T | Exchange Telephone Service - Foreign Exchange Service: All mileage rates. |
| 45-T | Private Line Services and Channels - Private Line Telephone Service: All items. |
| 46-T | Private Line Service and Channels - Private Line Teletypewriter and Morse Services: All items. |
| 47-T | Private Line Services and Channels - Channels for Program Transmission in Connection with Loudspeakers, Sound Reproduction or Sound Recording: All items. |
| 48-T | Private Line Services and Channels - Channels for One-way Speech Networks in Connection with Loudspeakers: All items. |
| 49-T | Private Line Services and Channels - Channels for One-way Program Transmission Networks in Connection with Loudspeakers: All items. |
| 50-T | Private Line Services and Channels - Supplemental Equipment: All items. |
| 51-T | Private Line Services and Channels - Move and Change Charges: All items. |
| 83-T | Special Assemblies of Equipment: All items. |
| 100-T | Exchange Telephone Service - Telephone Answering Service: All items. except those shown in Appendix F Page 24. |
| 102-T | Private Line Services and Channels - Channels for Video Transmission in Connection with Television Viewers: All items. |
| 104-T | Private Line Services and Channels - Channels for Remote Metering, Supervisory Control and Miscellaneous Signaling Purposes: All items. |

| Sched. No. | Name |
|---|---|
| 107-T | Private Line Services and Channels - Bell and Lights System Attack Warning Service: All items. |
| 111-T | Private Line Services and Channels - Special Assembly Services and Channels for Miscellaneous Experimental Purposes: All items. |
| 112-T | Exchange Telephone Service - Mechanized Switching System Service: Attendant's positions only. |
| 115-T | Private Line Services and Channels - Channels for Data Transmission: All items. |
| 117-T | Exchange Telephone Service - Airport Intercommunicating Service: All items except those items shown in Appendix F Pages 1 and 25. |
| 118-T | Private Line Services and Channels - Key Equipment Systems For Air Defense Communications. |
| 121-T | Centrex Service: All items except those items shown in Appendix F Pages 1 and 26. |
| 122-T | Private Line Services and Channels - Telpak Channels and Services: All items. |
| 126-T | Private Line Service and Channels - Channels for Television Transmission for use in Educational Television Systems: All items. |
| 133-T | 50 Kilobit Switched Service: All items. |
| 134-T | Private Line Services and Channels - Wideband Service: All items. |
| 135-T | Connections of Customer-Provided Equipment and Systems: All items. |
| 139-T | Private Line Services and Channels - Channels for Remote Operation of Private Mobile Radiotelephone Systems: All items. |
| 142-T | Private Line Service and Channels - Continuous Time Announcement Service: All items. |
| 144-T | Exchange Telephone Service - Supplemental Billing Service: All items. |
| 145-T | Entrance Facilities for Domestic Satellite Common Carriers: All items. |
| 150-T | Facilities for Other Common Carriers: All items. |
| 155-T | Exchange Telephone Service - Automatic Call Distributing Service: All items. |
| 156-T | Dataphone Digital Service: All items. |
| 158-T | Exchange Telephone Service - Electronic Tandem Switching: All items. |

Pacific shall file, coincident with the advice letter filing to implement the above surcharge, the derivation of the uniform percentage surcharge to be applied to the listed tariff schedules. Such derivation shall include the 1981 annual recurring and non-recurring revenue bases for each listed schedule and the portion of the authorized increase associated with each listed schedule. No repression effects shall be considered in the development of the surcharge. Such filing shall be open for public inspection and a copy of the filing shall be provided to each of the parties listed in Appendix A of this order.

END OF APPENDIX F

APPENDIX G
Page 1

## Chronology of the Accelerated Tax Depreciation Issue

NOTE: In the interest of brevity this chronology omits discussion of the following:

1. Investment tax credit (job development investment credit).
2. State tax treatment.
3. General Telephone Company of California.

1954 Section 167 of the Internal Revenue Code enacted, permitting corporations to employ straight-line depreciation or accelerated depreciation for income tax purposes.

1961 In C.6148 the Commission issued D.62585, (1961) 59 CPUC 119, on rehearing of D.61711, (1961) 58 CPUC 564, permitting transfer of tax reserves to depreciation reserve. The Commission stated it would continue to deduct from rate base tax reserves resulting from accelerated depreciation and reduce test year tax expense by the amount of such charges to the reserve for those utilities on accelerated depreciation basis. The decision to elect straight-line or accelerated depreciation was left to the utilities.

1968 In fixing rates in A.49142, a general rate application of Pacific, the Commission, in D.74917, (1968) 69 CPUC 53, imputed the use of accelerated depreciation for tax purposes in the test year 1967; gross revenue requirements were reduced by $4,829,000. Pacific continued to use straight-line depreciation for tax purposes.

1969 Section 441 of the Tax Reform Act of 1969 became law. It provided that utilities which had been straight-line taxpayers prior to August 30, 1969 would not be allowed to take accelerated depreciation unless normalization was used in fixing the utilities' rates. After August 30, 1969 Pacific elected to take accelerated depreciation.

1970 In D.77984, (1970) 71 CPUC 590, a declaratory interim opinion in a general rate application of Pacific, the Commission stated it would use straight-line depreciation

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to compute Pacific's tax expense and depreciation expense for ratemaking purposes and would give recognition to the normalized tax reserve in determining rate base.

1971 In City and County of San Francisco v Public Utilities Commission (1971) 6 Cal 3d 119, the Supreme Court unanimously annulled D.77984. The opinion stated that imputation of accelerated depreciation and flow-through in D.74917 is favorable to the ratepayer but harsh on Pacific. But, the method adopted in D.77984 is harsh on the ratepayer and beneficial to Pacific. It further stated that the Commission is not compelled to adopt one of the two extremes set forth above but may adopt a compromise striking a balance between the interests of the ratepayers and Pacific.

1972 The Court annulled D.78851 in City of Los Angeles v Public Utilities Commission (1972) 7 Cal 3d 331. Among other reasons the Court annulled because the Court's decision (6 Cal 3d 119) on the Commission's tax expense decision (D.77984) was filed after the Commission issued the instant decision. The Commission in fixing the rates at issue before the Court followed its tax expense decision. Since the latter decision was annulled so must the instant decision.

1974 The Commission again considered the tax depreciation question in D.83162, (1974) 77 CPUC 117, 158-170. The proceeding involved a general rate increase request by Pacific. It reexamined the tax issue because of annulments by the Supreme Court of D.77984 and D.78851. A number of methods of accounting for depreciation were presented and explored at great length. Based on its interpretation of the Tax Reform Act of 1969, the Commission concluded that it could not impute flow-through to Pacific without making Pacific ineligible for accelerated depreciation.

The Commission, though it rejected the plan, gave much thought to adopting what it called "the extraordinary item adjustment." This adjustment would have been an amount equal to the projected three-year average deferred tax reserve based on an assumed three-year rate case interval.

The increases in rates granted were made subject to refund.

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1975 On appeal the Supreme Court, in City of Los Angeles v Public Utilities Commission (1975) 15 Cal 3d 680, annulled that portion of the increase granted Pacific by D.83162, which related to accelerated tax depreciation as well as investment tax credit.

In D.85287, December 30, 1975 (79 CPUC 240), involving a general rate request of Pacific, the Commission noted that the Court's order in City of Los Angeles v Public Utilities Commission was not final and fixed rates on a normalization basis subject to refund, after considering other new and different solutions. The Commission concluded that "These interwoven questions are best considered at supplementary hearings, which we will set expeditiously by further order."

1977 D.87838 (1977) 82 CPUC 549 opened with the following words, "This is the latest and hopefully the final, proceeding on the long and tortuous road involving the regulatory rate treatment of accelerated tax depreciation...." This proceeding resulted directly from the remand by the Supreme Court in City of Los Angeles v Public Utilities Commission, where the Court ordered the Commission to consider methods of adjustment of tax expense other than normalization. Enactment of the Tax Reform Act of 1969 permitted utilities to now take accelerated depreciation only if the cost of service, including federal income tax expense, was computed on a normalization basis. Imputation of flow-through now would result in the loss of eligibility for accelerated depreciation and would create a huge tax liability, theoretically payable from the deferred tax reserve, though this reserve is only a notation.

Again, numerous plans were presented. The variations proposed essentially included two themes: (1) reduction of rate of return and (2) some means of reflecting the increases in the deferred tax reserve in order to further reduce the rate base, the annual adjustment method. The adopted method is called the "averaged annual adjustment" (AAA). The method requires the use of test year tax expense and test year deferred tax reserve figures. Then using latest available estimates, computes for each of the three years following the test year the reduction in net revenues resulting from the increased deferred tax reserve, computes the resulting decreased tax expense for each year, and then averages the deferred tax reserve and federal tax expense for the four-year

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period. These results will then be used in the test year for a pending rate case.

For past years, the order directed refunds to Pacific's customers of more than $200 million (as of year-end 1977).

1978-79 Despite the hopeful opening words of D.87838, the order was stayed pending judicial review. The California Supreme Court denied review on July 13, 1978 and the U.S. Supreme Court on February 21, 1979. However, before D.87838 could become effective, Pacific and General filed actions in the U.S. Federal District Court seeking a continued stay of D.87838 pending resolution of tax issues with the Internal Revenue Service.

Pacific and General were unsuccessful in obtaining continued stays as the following sequence of federal court orders reflects:

- U.S. District Court, Central District of California: Order Dissolving Temporary Restraining Order and Denying Preliminary Injunction; and Findings of Fact and Conclusions of Law Re Denial of Motion for Preliminary Injunction, March 30, 1979.
- Decision of U.S. Court of Appeals for the Ninth Circuit on Appeal from the U.S. District Court, July 18, 1979.
- Order of Court of Appeals Denying Motion for Stay Pending Appeal to U.S. Supreme Court, July 27, 1979.
- Order of U.S. Supreme Court Justice Rehnquist Staying Order of U.S. Court of Appeals Pending Further Order, August 3, 1979.
- Opinion of Justice Rehnquist Dissolving Previous Stay and Denying Stay Pending Disposition by the Full U.S. Supreme Court, August 13, 1979.
- Order of U.S. Supreme Court Denying Stay Pending Petitions for Certiorari, October 1, 1979.
- Petition for Writ of Certiorari Denied, October 15, 1979.

1980 On February 13, 1980, D.91337 ordered approximately $381 million in refunds to customers of Pacific for the period August 1974 to the date of the decision. The refund based on the "AAA" method of treating accelerated depreciation and the "AA" method for investment tax credit. It is expected that litigation involving the IRS will continue before a determination of whether use of the "AAA" and "AA" methods for development of cost of service and rate fixing will maintain the utility's right to continue use of accelerated depreciation. Prospective rates were fixed on the full normalization basis to place a cap on Pacific's and General's potential (future) tax liability.

## Glossary

| | |
|---|---|
| AAA | Average Annual Adjustment |
| ALJ | Administrative Law Judge |
| Allied | Allied Telephone Companies Association |
| AT&T | American Telephone and Telegraph Company |
| Bell Labs | Bell Telephone Laboratories |
| BIS | Bell Labs Business Information Systems |
| Board | Franchise Tax Board |
| BSC | Business Service Center |
| CAPM | Capital Asset Pricing Model |
| CHMA | California Hotel and Motel Association |
| CIA | California Interconnect Association |
| Citizens | Citizens Utilities Company of California |
| COE | Central Office Equipment |
| Continental | Continental Telephone Company of California |
| CWIP | Construction Work in Progress |
| DCF | Discounted Cash Flow |
| Delphi | Delphi Corporation |
| ECAC | Energy Cost Adjustment Clause |
| EEO | Equal Employment Opportunity |
| EEOC | Equal Employment Opportunity Counsel |
| ESS | Electronic Switching |
| FCC | Federal Communications Commission |
| FEX | Foreign Exchange Service |
| General or GTE | General Telephone Company of California |
| GO | General Order |
| GSA | General Services Administration for Executive Agencies of the United States |
| IDC | Interest During Construction |
| IDDD | International Direct Distance Dialing |
| IMTS | Improved Mobile Telephone Services |
| IRS | Internal Service |
| IW | Interior Wiring |

## Glossary

| | |
|---|---|
| Justice | Department of Justice |
| KTS | Key Telephone Service |
| LA County | County of Los Angeles |
| LAEA | Los Angeles Extended Area |
| Long Lines | AT&T's Long Lines Department |
| Los Angeles | City of Los Angeles |
| MCI | Microwave Communications, Inc. |
| MSM | Multistate Marketing |
| MTS | Message Toll Service |
| NARUC | National Association of Regulatory Utility Commissioners |
| Nevada | Bell Telephone Company of Nevada |
| NOI | Notice of Intent |
| OCMS | Optional Calling Measured Service |
| OII | Order Instituting Investigation |
| ORTS | Optional Residence Telephone Service |
| 1FR | One-Party Flat Rate |
| 1MQ | One-Party Message Rate |
| 1MR | One-Party Measured Rate |
| 195 | 195 Broadway Corporation |
| OTCS | Telephone Operating Subsidiaries |
| Pacific or PT&T | Pacific Telephone and Telegraph Company |
| R&SE | Research and Systems Engineering |
| ROI | Return on Investment |
| Roseville | Roseville Telephone Company |
| San Diego | City of San Diego |
| San Francisco | City and County of San Francisco |

## Glossary

| | |
|---|---|
| SF-EBEA | San Francisco-East Bay Extended Area |
| SMRT | Single Message Rate Timing |
| Sonitrol | Sonitrol Telephone Assistance |
| Staff | PUC Technical and Legal Staff |
| TASC | Telephone Answering Services of California |
| TELSAM | Telephone Service Attitude Measurement Plan |
| Users Group | California Retailers Association, Tele-Communications Association, American Broadcasting Companies, Inc., and CBS, Inc. |
| WATS | Wide Area Telephone Service |
| WBFA | Western Burglar and Fire Alarm Association |
| Western | Western Electric Company |
| ZUM | Zone Usage Measurement |

#10

August 4, 1981

A. 59849

RICHARD D. GRAVELLE, Commissioner

I concur.

I write separately to stress my strong belief that we have not gone far enough in spelling out what we expect of Pacific, AT&T and the financial community in response to our 17.4 percent return on equity authorization and what will occur should that response not materialize.

We cannot allow ratepayer funds, in the form of increased returns on equity, to be substituted for the equity investment which the owner of a utility should provide to allow for necessary growth and modernization. To do so would improperly reverse the roll of consumer and investor. (See City and County of San Francisco v. Public Utilities Commission (1971) 6 Cal. 3d 119, 128-129). We can make a short term effort, as we do today, to meet an existing problem and to stimulate activity by the equity owner and the financial community. However, when we do so we should be crystal clear as to what we expect in return and what will happen if what we expect does not come to fruition.

I believe the return on equity should have been made conditional upon achievement of:

1) a 50 percent debt/equity ratio by January 1983;
2) an increase in Pacific's dividend, adoption by AT&T of a policy of reinvestment in Pacific of the proceeds attributable to the higher dividend, and announcement by Pacific of a clear dividend policy so that potential investors other than AT&T can evaluate what kind of return they are likely to receive, and
3) a positive response from the two principal rating agencies with respect to Pacific's credit rating.

We should have informed Pacific, AT&T and the rating agencies that if such goals were not achieved or were not substantially in the process of being achieved by the end of one year, then Pacific's return on equity would, without further hearing or inquiry, drop to 14.7 percent, with its rates adjusted accordingly. Such a level of return on equity is one which I believe would be fair to Pacific and its ratepayers but for the extraordinary financial condition in which AT&T has placed Pacific at this time.

Ratemaking is a difficult process under even the best of circumstances. Here Pacific has asked us to accept full responsibility for its debt offerings having been downgraded as if AT&T did not exist. Yet this Commission cannot ignore the fact that AT&T has deliberately placed Pacific in its weakened position. It was not this Commission, for example, which created the present normalization/flow through controversy but the California Supreme Court. AT&T chose not to recognize this but to "pick up its marbles and go home" by refusing to invest equity in Pacific. It let the common equity ratio fall from 47.82% in 1975 to 37.98% in 1979. (With approval today of $200 million of new debt offerings, Pacific's common equity ratio will fall to 34.6%). AT&T also chose to have Pacific deliberately seek an adverse tax ruling from the Internal Revenue Service with respect to eligibility for accelerated depreciation. AT&T has deliberately kept Pacific's dividend low while complaining loudly that the market value of its stock had fallen below book value. Yet no action of this Commission could have obscured from investors' eyes the simple fact that the dividend has been increased only once in the last 11 years. With this history in mind, I feel today's decision comes very close to rewarding AT&T for irresponsible behavior.

We do not allow for ratemaking purposes all of the expense which Pacific incurs under its license contract fee arrangement with AT&T or all of the expense which Pacific incurs for purchases from Western Electric or services from Bell Labs. However, this does not negate the fact that very large sums move to AT&T from Pacific for these expenses. For one example, if we estimate the amount of net income Western Electric receives from Pacific at $103 million on gross 1980 revenues of $1.5 billion, and add to that sum the $121 million paid to AT&T in license contract fees, we see the total payment out of Pacific for these items alone exceeds the 1980 common equity dividend payments from Pacific to AT&T of $216 million. Other hundreds of millions of dollars also flow directly to AT&T from Pacific in forms of tax payments which are ephemeral, and payments for other services, none of which has ever been justified as being directly beneficial to Pacific or its ratepayers. In other words, Pacific is a very profitable operation for AT&T, even if the dividend level remains at $1.40 per year. In light of its posture in exacting these huge cash flow demands from Pacific, which are always paid, AT&T has a correspondingly large obligation to supply capital to Pacific rather than complain that this Commission does not permit it to earn an adequate profit.

As the decision indicates, ratemaking is a cooperative enterprise. We are not alone in our regulatory relationship with Pacific; others unregulated by us must abide by the rules of the regulatory game or there is no game.

If AT&T for whatever reason decides that it will not avail itself of the opportunity to increase its earnings through increased equity investment in Pacific, then there is nothing more we can do to save Pacific's financial integrity. We will have no alternative but to recognize that fact by immediately reducing the ratepayers' contribution to equity.

If the rating agencies in spite of AT&T's commitment to correct the imbalance in Pacific's capital structure continue lowered ratings for Pacific's debt, thereby exacting unnecessary costs from California consumers, we should recognize that fact by immediately reducing the ratepayers' contribution to equity. Further, should a downgrading occur, we should request legislative inquiries at both the state and federal level into the practices and procedures of the rating agencies to determine why they are in a position to exact costs upon ratepayers without ever having to face public scrutiny. We will also have grounds for simply disregarding their ratings when we next determine the level of return on equity, since we will have established that even extraordinary action, such as that taken today, has no effect upon such ratings. If the rating agencies wish to write themselves out of the regulatory game, that is their decision. In the final analysis, the ratings process relies on substantial subjective input. A downgrading in response to the highest return on equity authorized any comparable utility would prove how subjective that process is.

It is, of course, my hope that none of these adverse reactions to today's decision will ever come to pass, rather that AT&T, Pacific and the financial community will respond as we expect and the regulatory process can go forward with a renewed spirit of cooperation to the benefit of both Pacific's customers and its owners.

Richard D. Gravelle

RICHARD D. GRAVELLE, Commissioner

A.59849

A.59269, A.59858, A.59888, OII 63 & OII 81

LEONARD M. GRIMES, JR., COMMISSIONER

I concur.

But in doing so, I am of the belief that although we authorized the full amount requested by Pacific for modernization, the benefits to our ratepayers did not receive the elaboration that the decision deserves. In addition to preventing deterioration of the good service demanded by ratepayers, the more rapid installation of the latest state-of-the-art equipment and systems is the real practical strategy to meet the continued pressure of growth and demand for high service quality. Delay and generally slowing the pace of replacing outmoded, obsolete equipment and systems in our country will only result in higher cost to consumers when deferred maintenance catches up with all of us.

The new on the shelf and planned electronic systems offer substantial cost savings in both telephone plant operations and to the residential and business consumer. A modern system provides the opportunity for consumers to virtually design their own phone service to fit their need and pocket book. The telephone is no longer completely a discretionary part of our lives. It is getting increasingly more vital to the health and welfare of the entire community, and must therefore receive the kind of care and attention critical services should and must have. It has been shown that the health of a nation is reflected in the upkeep of its capital stock.

Our staff recommended in the proceeding (and historically) a reduction-deferred without being detrimental-in funds requested for modernization. While I certainly do recognize the need for setting limits, I am convinced that not enough weight was given to the almost immediate benefits accruing from a "modernization investment." In all fairness to our staff, however, I do not think that Pacific has made its best presentation to this Commission on several issues, and I can only hope that we can look forward in the future to the development of the kind of record that will permit some forward and creative movement. A case in point was the weak record that precluded a defensible consideration of short term CWIP, a useful tool to improve internal cash generation and save ratepayer's high interest expenses for plant modernization (See Page 111). It will take courage not to be "pennywise and pound foolish" -- an easy trap to fall into when the "crunch" is on as it is today!

As the assigned Commissioner for this proceeding, I would also like to express some of the frustrations facing this Commission and other similar agencies today. This decision is based on a voluminous record consisting of 362 exhibits thoroughly cross-examined in 86 days of hearings spanning several months and producing nearly 10,000 pages of transcript. As the proceeding developed, I could not help being reminded once again that the adversary procedures we currently must follow have serious deficiencies.

Of course, this proceeding analyzed several issues of major import in the current transition facing telecommunications. Yet one could see a substantial diversion of effort on the most minor of items by the company, our staff, and several intervenors participating in this process. It seems that the mere availability of an adversary forum leads to a glorification of the process without a clear sense of true priorities or of the need to develop a record containing a full range of options for the Commission. A recent line from some of my reading comes to mind here, "... prolonged hostilities provide a continuing showcase for tactical acumen and warlike aggressiveness."

I am also concerned about some of the unintended side effects of our Regulatory Lag Plan. I am unalterably convinced of the need for firm scheduling of Commission proceedings. However, I believe that twelve month review period for major rate cases is far longer than necessary and will support all reasonable efforts to reduce this period. Yet, even with this inordinate length of time Parkinson's law still operates and to produce a timely result, we had to adopt the technique of limiting the dates beyond which no new evidence can be offered. Obviously, the line must be drawn somewhere. At some point all parties must be told that no new issues can be raised. But there should be a way to update the information in the record on those issues that have already been raised.

Our staff filed data on many issues that Pacific agreed was superior to that the company had filed. The reason the staff data was better in many cases was a result of having later information available. One can only wonder how this decision could have been improved had we access to even later information on such matters as inflation, cost of money, actual growth rates, actual rate base, and many other areas subject to relatively straightforward validation. Much of this information is in the physical possession of the Commission but could not be used in this decision because the record had been closed. One must wonder if a slavish adherence to procedure is producing some rather absurd consequences. As we sign today, we are calling for yet more hearings on what may prove to be the more important issues in this case. We shall try to heed the old saying, "You study long; you study wrong." Finally, it was quite apparent from my seat that our prcedural tradition is not suited in many respects to today's realities. For the many decades in which both rates and regulatory policy were relatively stable, the process was probably the best way to zero in with precision on the "numbers." Today we are in the midst in the most fundamental overhaul of governmental regulatory policy that has occurred in most of our lifetimes. While our hearings pursue the numbers, the rapid and necessary shifts in policy can totally overwhelm any consequence the numbers may have.

I am convinced that few of us would suggest that this adversarial process is well suited to policy development. Only open discussion can produce a sense of direction and sound policy judgments. We need the best facts our adversarial proceedings can provide, but we also need some more informal procedures in which the Commissioners, the company, and the public can reason together rather than cross-examine, and can reflect on each others views rather than prepare for the next attack.

It goes without saying that there is a need to protect the due process rights of the public and all participants. I cannot accept, however, that we must insist on the complete exclusion of more deliberative and I believe more productive interchange. Regulation by pure confrontation is simply warfare, and nobody wins.

If the public-business-government relationship in this state and the rest of the nation cannot co-exist in a collaborative and responsible manner, then we are in more trouble than we imagined.

In this concurrence, it is important that I indicate that the 17.4% return on common equity granted in this decision is easily defensible and supportable from my perspective; and further, the funds to achieve that level of return have also been provided.

LEONARD M. GRIMES, JR., COMMISSIONER

San Francisco, California
August 4, 1981

COMMISSIONER JOHN E. BRYSON, Concurring:

I concur in our decision to grant Pacific Telephone a $610.1 million rate increase. In order to attract capital for Pacific's substantial construction program and to maintain service quality, higher rates are necessary.

A major reason for the higher rates is the significant increase in Pacific's capital costs. This decision increases Pacific's authorized return on rate base from 10.25% to 12.91%, and its return on equity from 12.25% to 17.4%. These increased returns reflect the higher price Pacific and all borrowers must pay in a time of rising interest rates. Table 1 illustrates how costs have increased for short and long term Treasury notes over the past 4 years. Because Treasury notes represent debt issued with the full backing of the federal government, they are the least risky securities for a given term length available in our economy. As Treasury rates increase, so must the rates for all other securities. Investors will not, for example, buy Pacific stock earning 12.25% (the return authorized in our last general rate case decision) when Treasury rates are above 14%. If Pacific continued earning such a return on its book assets, the market price for its stock inevitably would remain far below book value, and new equity could not be issued without diluting existing shareholders' earnings. With Pacific's long term bonds yielding 15-16% per year and with its short term borrowing selling at even higher rates, the 17.4% return authorization is necessary to fairly compensate equity investors who take greater risks than the investors in Pacific's bonds and short term notes.

While Table 1 illustrates the general direction capital costs have taken in recent years, it also illustrates the volatility of the market. A return authorization that is appropriate one month can become inappropriately high or low soon thereafter because of changes in the economy generally. In the more stable past, we did not need to concern ourselves greatly with market swings because they were relatively minor. Today, market fluctuations are so great that our judgment as to the appropriate return is often soon engulfed by general market movements.

I believe we should more systematically account for market volatility. To do this, we could adjust our return authorizations at regular intervals based on changing conditions. I request that the staff consider various alternative mechanisms for such an adjustment in its current review of our return on equity methodology. Such a change in ratemaking would assure customers that their rates would be reduced should interest rates fall, and give lenders confidence that this Commission is responsive to market conditions. Greater investor confidence would ultimately translate into relatively lower capital costs and lower customer rates.

To this end, the Commission could consider establishing returns by determining the appropriate risk premium associated with investment in the utility in question over the relatively risk-free Treasury borrowing. The total return could then be adjusted at intervals based on changing Treasury rates. For example, if we authorized a return of 17% in a particular case based on a current Treasury rate of 13%, and if one year later the Treasury rate was 10%, we would adjust the return downward to 14%. If Treasury rates increased, we would make an upward adjustment. The premium itself would not change, but the floor would be adjusted to reflect current conditions.

Should we adopt such an approach, many issues would need to be settled. One question is the term length for the Treasury bond to be used as a base. Conceptually, a short term rate that covers the period over which the decision is to apply might be appropriate, but such short term rates are more unstable than longer term rates, possibly creating undesirable volatility in customer rate levels and utility revenues. Whatever base decided upon, consistency in application would be most important in order that investors have confidence that their investments will be adequately compensated over time. Another issue would be how to determine the premium above the Treasury rate. I would suggest that most of the methods now employed such as the comparative earnings test, the capital asset pricing model, and interest coverage tests all could continue to be employed. The only difference would be that the debate would center on the premium above the Treasury bond base, which would become an integral part of each rate case application.

Just as the cost of equity is fluctuating in an upward direction, so is the cost of debt. As debt is retired and new debt added, the total cost to the company increases. To take into account these increasing costs, I would suggest considering in future general rate decisions adoption of a step rate adjustment at the end of each year to establish rate of return on rate base at the current imbedded cost of debt. Through such an adjustment, financial attrition would be corrected and earnings stabilized, making utility investments more attractive.

By establishing a method for adjusting returns to changing market conditions, customer rates over time should be lower. As investors gain confidence that the regulatory process will reflect current conditions, one major risk associated with utility debt and equity issued is reduced. Consequently, the cost for both instruments should be lower which should in turn benefit ratepayers by allowing lower rates.

Another potential advantage of adopting periodic adjustments for debt and equity would be to lengthen the period between rate case applications. Since financial costs appear to be the major source of upward pressure on telephone company rates, the adjustments suggested might be the only rate relief required over several years. One obvious benefit would be to relieve the staff, the company, and intervenors from lengthy proceedings. More significantly, an extended period between rate cases would provide management with greater incentives to cut costs and improve productivity.

An important rationale for privately owned utilities traditionally has been that private utilities had incentives for efficient management. Because rate cases were infrequent, stockholders' earnings improved as cost reductions occurred, providing a strong incentive for good performance. Ratepayers ultimately benefited too, through lower rates when the less frequent rate case decisions were reached and through lower debt and equity costs.

Today, with rate case decisions every two years or even more often, much of the traditional incentive is lost. Instead, I fear that our regulatory process is creating incentives for a cost-plus culture at utilities in which expenses are incurred to buttress the next rate increase. Reduced incentive exists for management efficiency when there is little time between rate cases during which operating savings can provide enhanced earnings for investors. By adjusting for financial attrition, we may be able to lengthen the period between rate cases. The benefits of improved productivity or the cost of poor management would then be more directly felt by stockholders, providing improved incentives for management efficiency.

In addition to step rates for financial attrition, similar reasoning persuades me to invite proposals from our staff and others to employ for step rates between rate cases general indices of other major cost components such as wage expense. Here, if the Commission were to establish step rates according to general cost standards, utility management would have an economic incentive to control its costs between rate cases in the form of increased or reduced earnings depending on how actual costs matched these general indices. (In the case of telephone companies, these indices would need to be offset by expected productivity improvements and by the increasing economies of scale that occur with increased usage.) Again, the ratepayers would have the ultimate benefit of improved management and cost control which would be reflected in all subsequent rate proceedings.

Inflation and financial market volatility will remain with us for years ahead. We need to continue to adapt our ratemaking process to this more turbulent environment to provide reasonable conditions for attraction of capital while at the same time providing incentives for good utility management. Ratemaking changes to reflect changing financial market conditions and the impact of inflation on utility costs are ideas worth exploring to improve our methods of regulation.

San Francisco, California
August 4, 1981

JOHN E. BRYSON, President

TABLE I

U.S. TREASURY RATES

OVER PAST FOUR YEARS

| | | | Three-Month T-Bill 1/ | Two-Year T-Bill 1/ | 10-Year Treasury Bonds 1/ |
|---|---|---|---|---|---|
| 1977 | Jan. | - | 4.62 | 5.90 | 7.21 |
| | April | - | 4.54 | 5.97 | 7.37 |
| | July | - | 5.19 | 6.27 | 7.33 |
| | Oct. | - | 6.16 | 7.11 | 7.52 |
| 1978 | Jan. | - | 6.44 | 7.49 | 7.96 |
| | April | - | 6.29 | 7.74 | 8.15 |
| | July | - | 7.01 | 8.49 | 8.64 |
| | Oct. | - | 7.99 | 8.85 | 8.64 |
| 1979 | Jan. | - | 9.35 | 9.86 | 9.10 |
| | April | - | 9.46 | 9.78 | 9.18 |
| | July | - | 9.24 | 9.14 | 8.95 |
| | Oct. | - | 11.70 | 11.49 | 10.30 |
| 1980 | Jan. | - | 12.00 | 11.50 | 10.80 |
| | April | - | 13.20 | 12.50 | 11.47 |
| | July | - | 8.06 | 9.03 | 10.25 |
| | Oct. | - | 11.62 | 12.09 | 11.75 |
| 1981 | Jan. | - | 15.02 | 13.26 | 12.57 |
| | April | - | 13.62 | 14.15 | 13.68 |
| Current Rate 2/ | | - | 15.23 | 15.69 | 14.64 |

1/ Source: Federal Reserve Bulletins
2/ Source: Wall Street Journal, Monday August 3, 1981