

## Opinion No. 49-5243

August 22, 1949

**BY:** JOE L. MARTINEZ, Attorney General

**TO:** Dan R. Sedillo, Chairman State Corporation Commission Santa Fe, New Mexico

{\*82} On July 19, 1949, Mr. Allison requested this office to attend the hearing on the petition of the Mountain States Telephone & Telegraph Company to increase its exchange and toll rates in the State of New Mexico. I, together with Mr. Dunleavy of this office, attended the hearing which lasted from July 21 through July 23, 1949.

An August 2, 1949, you issued your order approving the increase in rates as already put into effect by the telephone company. It is the opinion of this office that the conclusions contained in your order are contrary to the facts and to the law applicable in cases of this kind, and I am taking this opportunity to advise you of the reasons for this conclusion and of the action I intend to take.

The telephone company, in its presentation of its case, based its demands on what it considered its investment in the state for intrastate use. The company represented its investment as reproduction cost, now, of their total property, or what is known as "present value." They included in this figure \$ 1,182,000.00 for plant under construction and an additional \$ 43,000.00 for interest charged on money used during construction. The result was to give the telephone company a theoretical investment in the state of \$ 16,835,000.00. With this total as a rate base, the company showed that if the rates that had been in effect as of January 1, 1949, had continued throughout the year, the company would have had a return on this investment of 2.67%.

If the rates which they put into effect on June 10, 1949, were to remain in effect for the remainder of the year, it would produce a rate of return of 4.09%. If the rates put in effect as of June 10, 1949, had existed throughout the year, the company would have had a return of 5.29%.

This theory of reproduction cost, now, is based on the obsolete and thoroughly repudiated principles contained in the case of *Smith v. Ames*, 169 U.S. 466, where the United States Supreme Court accepted the doctrine of "present value" as a rate-making base. In *Power Commission v. Pipeline Company*, 315 U.S. 575, decided March 16, 1942, the Court took the opportunity to lay the ghost of *Smith v. Ames*, which has haunted utility regulation since 1898. See, also, *Power Commission v. Hope Gas Co.*, 320 U.S. 591, to the same effect. As has been aptly observed, the reproduction or present value theory has diverted "the time, attention and funds of regulatory agencies out of their proper channels into one of the most unreal fields of speculation in which the minds of meta-physicians have disported themselves since the days of medieval schoolmen."

{\*83} As the hearing developed and the telephone company realized that it was meeting serious objection to the reproduction cost theory, it shifted its position to that of original cost or actual investment as a rate base. Under this approach to the problem, the company showed an actual investment in the state of \$ 14,795,000.00. With this sum as a rate base it was developed that if the rates in effect as of January 1, 1949, continued in effect, the company would have earned 3.04% of their investment. If the new rates which took effect on June 10, 1949, had been in effect during the year, the company would have earned 6.01%, and finally, should the rates of June 10, 1949, be continued for the remainder of the year, the company will have earned 4.66%.

At this point, it was developed that during the course of its investment in the state, the company had accumulated a depreciation reserve of \$ 2,687,000.00 which should properly be deducted from the \$ 14,795,000.00 to make the net investment \$ 12,108,000.00. With this as a rate base, the company would have earned 3.72% on its investment if the rates of January 1, 1949, had continued in effect; 7.34% if the rates of June 10, 1949, had been in effect for the entire year, and 5.69% if the rates of June 10, 1949, were to continue in effect for the period from June 10, to the end of the year.

In all of the rate bases heretofore used there was included \$ 1,182,000.00 for "plant under construction" and \$ 43,000.00 for interest charged on money used in the construction program. It is uniformly held by the utility regulatory bodies of the Federal Government that a rate base is bottomed on "telephone plant **in service.**" The utility is entitled to a return on its plant which is actually rendering useful service to the public. Its proposed additions must be rendering a service to the people before such expenditures or contemplated expenditures can be incorporated in any rate base. Subscribers do not have the responsibility of financing the expansion of utility programs. The financing program is the sole responsibility of the company.

Each of the above mentioned rate bases would have to be reduced by \$ 1,182,000.00 and further by \$ 43,000.00. This results in a complete change in the earning picture. For example, the actual investment of the company based on original cost, less the depreciation reserves, less the \$ 1,182,000.00 of plant under construction, and the \$ 43,000.00 interest charged during construction would reduce the actual known investment of the telephone company in the State of New Mexico for intrastate purposes to \$ 10,926,000.00. This is a substantial difference. On the basis of this actual known and measurable investment of the utility company in the state, the company would then be receiving on the basis of the rates in effect as of January 1, 1949, 3.73% on its investment. If the rates in effect as of June 10, 1949, had been in existence for the entire year, the company would earn 7.75% on its investment. If the rates of June 10, 1949, are allowed to continue for the remainder of the year, the company will be earning 5.91%. Projecting these figures into 1950, the company will earn in excess of 7% during the year 1950 on its actual investment in New Mexico.

The telephone company placed great emphasis in its request for additional income on its precarious financial position. It made a strong showing that it was encountering great difficulty in raising equity or stock capital. This complaint should be taken with

considerable caution. Witnesses for the company admitted that it was a subsidiary of A.T. & T., the largest corporation in the world, and that A.T. & T. owned more than 81% of the outstanding {\*84} stock in the Mountain States Telephone and Telegraph Company. Their witnesses further testified that A.T. & T. \$ 100.00 par stock was, as of the date of the hearing, selling for \$ 141.00 on the New York Stock Exchange and paying a dividend of \$ 9.00 per share. It is a little difficult to become sympathetic because of the weakened condition of the finances of the Mountain States Telephone and Telegraph Company and its parent corporation, the American Telephone and Telegraph Company.

It should also be pointed out that the earnings heretofore described are not in themselves true indications of the ability of the telephone company to pay dividends. It is admitted by the witnesses for the telephone company that 53% of its indebtedness is debt or leverage capital and that the highest interest rate paid on this money is 3.12%. On this 53% of its indebtedness the Commission, under its rate increase approval, is allowing at least twice this amount. On its equity or stock capital the company could therefore pay by way of dividends substantially more than the rate of return allowed by the Commission.

I would also like to point out what I consider certain substantial errors in the Order which you have prepared. You state Mr. Learned, who was the consulting engineer, and hired by the State Corporation Commission, stated that under no circumstances would he use the book value cost as a rate basis. In addition to relying on memory, the record has been carefully scrutinized and no such statement is made. Mr. Learned fully understood that the Federal Power Commission, the Federal Communications Commission, the Securities and Exchange Commission and the more progressive of the state regulatory bodies use the original cost less depreciation as a rate basis. Further, in your Order you state that you place a great deal of emphasis on the present value theory and then by a kind of non sequitur come to the conclusion that "the Commission finds the proper average evaluation of the intrastate property of the company for the year of 1949 for the purposes of this case to be not less than \$ 13,000,000.00." The method of arriving at the figure of \$ 13,000,000.00 is totally unintelligible and is contrary to the facts under the applicable law.

It should be clearly understood that this office is not in any way opposed to a rate increase provided it has a basis in fact and reason. The principles used in arriving at a rate base and a return should be made crystal clear in order that the public and the utilities may understand their position in these matters. The Public will know what it is paying for and the utility will be allowed an adequate and proper return on its investment.

I am fully aware of the fact that under the terms of the Constitution of the State of New Mexico the Attorney General is the attorney for the State Corporation Commission. I realize further that I am the attorney for the people of the State of New Mexico and my primary and paramount obligation is to the people of the state. Since, therefore, I cannot agree with the action you have taken and since it has a serious effect on the people of

the state, I am at this time advising you that I am withdrawing my counsel for the Corporation Commission in this matter. I am sure that the telephone company will supply you with the best possible counsel in order to sustain your position.

I intend in a very short time to appeal this cause to the Supreme Court for review and will be joined in this by several of the attorneys who appeared from various communities throughout the State.