



1976 Annual Report

Telephone Utilities, Inc.

file: Pacific Telecom, Inc

Telephone Utilities, Inc.**CONSOLIDATED BALANCE SHEET**

December 31, 1976 and 1975

1976

1975

Assets

Telephone plant:

Telephone plant in service (Notes 1 and 3)	\$110,709,902	\$100,407,283
Less accumulated depreciation	23,192,791	19,862,048
	87,517,111	80,545,235
Construction work in progress	2,741,583	2,923,720
Net telephone plant	90,258,694	83,468,955

Cost of acquisitions in excess of equity in
net assets of subsidiaries (Note 1)**10,522,753** 9,670,732

Current assets:

Cash	379,328	272,884
Temporary cash investments (Notes 2 and 7)	5,623,259	4,275,575
Accounts receivable	3,791,565	4,089,218
Material and supplies (Note 1)	1,576,414	1,512,077
Prepayments	201,885	231,658
Total current assets	11,572,451	10,381,412

Unamortized debt expense and other deferred charges

417,651 441,575**\$112,771,549** **\$103,962,674***See accompanying notes.*

1976

1975

Capitalization and Liabilities

Shareholders' equity (Notes 2 and 4):

Common stock, authorized 12,000,000 shares of \$1 par value, 4,728,079 shares outstanding	\$ 4,728,079	\$ 4,728,079
Preferred stock, 6% cumulative, authorized 152,000 shares of \$25 par value, 23,628 shares issued less 3,313 shares of treasury stock at par value	507,875	507,875
Capital in excess of par value	26,782,317	26,782,317
Retained earnings (Note 3)	16,543,662	13,153,234
Total shareholders' equity	48,561,933	45,171,505

Minority interest in subsidiaries:

Common stock and retained earnings	235,059	203,690
Preferred stock	320,750	320,750
Total minority interest in subsidiaries	555,809	524,440

Long-term debt (Note 3)	45,206,107	44,873,866
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Current liabilities:

Accounts payable	5,843,934	2,929,543
Income taxes payable (Note 2)	707,648	215,789
Dividends payable	378,246	330,965
Accrued liabilities	1,440,151	1,944,266
Advance billings	867,311	769,337
Current maturities on long-term debt (Note 3)	1,484,288	1,550,932
Total current liabilities	10,721,578	7,740,832

Deferred income taxes (Note 1)	4,800,372	3,691,372
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Deferred investment tax credit (Note 1)	2,800,551	1,815,530
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Other deferred credits	125,199	145,129
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	<u>\$112,771,549</u>	<u>\$103,962,674</u>
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See accompanying notes.

Telephone Utilities, Inc.**CONSOLIDATED STATEMENT OF RETAINED EARNINGS**

Years ended December 31, 1976 and 1975

	1976	1975
Balance at beginning of year	\$13,153,234	\$10,767,894
Net income	4,790,946	4,210,665
	17,944,180	14,978,559
Deduct:		
Cash dividends:		
Common stock (Per share: 1976— \$.29; 1975— \$.07)	1,370,045	330,965
Preferred stock	30,473	30,473
5% common stock dividend, at market value at date of declaration		1,463,887
	1,400,518	1,825,325
Balance at end of year (Note 3)	\$16,543,662	\$13,153,234

Telephone Utilities, Inc.**CONSOLIDATED STATEMENT OF CAPITAL IN EXCESS OF PAR VALUE**

Years ended December 31, 1976 and 1975

	1976	1975
Balance at beginning of year	\$26,782,317	\$25,551,505
Excess of market value over par value of common stock dividend		1,230,812
Balance at end of year	\$26,782,317	\$26,782,317

See accompanying notes.

Telephone Utilities, Inc.**CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION**

Years ended December 31, 1976 and 1975

1976**1975**

Source of working capital:

From operations:

Net income	\$ 4,790,946	\$ 4,210,665
Items not involving working capital:		
Depreciation and amortization	6,041,482	5,497,057
Minority interest	39,835	31,620
Allowance for funds used during construction	(273,058)	(378,505)
Deferred income taxes and investment tax credit	2,073,000	1,847,000
Total from operations	12,672,205	11,207,837
Long-term debt issued and assumed in connection with purchase of subsidiaries	1,807,312	1,454,100
Salvage from plant and equipment retired	805,184	670,486
Decrease (increase) in working capital	1,789,707	(1,092,723)
	<u>\$17,074,408</u>	<u>\$12,239,700</u>

Application of working capital:

Property, plant and equipment:

Additions to telephone plant in service	\$12,615,526	\$11,794,348
Change in construction work in progress—net	(182,137)	(2,683,299)
	12,433,389	9,111,049
Allowance for funds used during construction	(273,058)	(378,505)
	12,160,331	8,732,544
Acquired in connection with purchase of subsidiaries—net	898,637	867,154
	13,058,968	9,599,698
Addition to cost of acquisitions in excess of net assets of subsidiaries	798,476	442,971
Reduction of long-term debt	1,475,071	1,527,241
Cost of removal of plant and equipment	268,479	261,488
Dividends	1,400,518	361,438
Other—net	72,896	46,864
	<u>\$17,074,408</u>	<u>\$12,239,700</u>

Decrease (increase) in the elements of working capital:

Cash and temporary cash investments	\$ (1,454,128)	\$ (256,945)
Accounts receivable	297,653	1,296,630
Material and supplies	(64,337)	539,342
Other current assets	29,773	130,605
Accounts payable	2,914,391	(3,030,128)
Income taxes payable	491,859	(682,191)
Current maturities on long-term debt	(66,644)	189,050
Other current liabilities	(358,860)	720,914
	<u>\$ 1,789,707</u>	<u>\$ (1,092,723)</u>

See accompanying notes.

Telephone Utilities, Inc.

Notes to Consolidated Financial Statements

1. Summary of significant accounting policies

(a) Basis of presentation

The consolidated financial statements include the accounts of Telephone Utilities, Inc. (T.U.) and its subsidiaries (Company), all majority-owned. All appropriate intercompany transactions have been eliminated.

In November 1976, T.U. purchased all of the outstanding stock of Eastern Oregon Telephone Company for \$1,478,000. In August 1975, T.U. purchased all of the outstanding stock of Blue Mountain Telephone, Inc. and Fossil Telephone Exchange for \$720,000. Operating results for those companies from the dates of purchase are included in the accompanying consolidated statement of income. Consolidated results of operations for the two years ended December 31, 1976 would not be materially affected by the inclusion on a pro forma basis of the operating results of the purchased companies.

(b) Regulatory authorities

The accounting policies of the Company are in conformity with the requirements and authorizations of the regulatory agencies of the various states in which the Company operates.

(c) Telephone plant

Telephone plant is stated at cost. Additions to telephone plant represent direct costs, indirect charges for engineering, supervision and similar overhead items, and an allowance for funds used during construction. Maintenance and repairs are charged to expense as incurred. Betterments and renewals of items considered to be identifiable items of property are charged to plant accounts. Accumulated depreciation is charged for ordinary retirements and the cost of the removal of assets retired and is credited for proceeds from sales and salvage.

Depreciation is provided using the straight-line method over the estimated service lives of the various classes of depreciable assets. The average composite depreciation rate used for telephone plant was 5.9% in 1976 and in 1975.

(d) Cost of acquisitions in excess of equity in net assets of subsidiaries

The cost in excess of the carrying value of net assets of purchased subsidiaries of \$9,238,835, applicable to

acquisitions entered into prior to November 1, 1970, is not being amortized since, in the opinion of management, there has been no diminution of its value. The cost in excess of the carrying value of net assets of purchased subsidiaries of \$1,306,068, applicable to subsidiaries purchased subsequent to November 1, 1970, is being amortized over 40 years.

(e) Material and supplies

Material and supplies are stated at average cost.

(f) Pension plans

Substantially all employees are covered under the pension plans of the Company. Pension costs were \$366,310 in 1976 and \$292,793 in 1975, including applicable provisions for unfunded past service costs. Current service cost is funded as the liability accrues. Past service costs are being amortized over a ten year period. At January 1, 1976, the unfunded past service costs were approximately \$585,000.

(g) Income taxes

Federal income tax is allocated to T.U.'s subsidiaries on the basis of their filing separate federal income tax returns.

Deferred income taxes are provided for the income tax reductions resulting from the additional depreciation deduction allowed by the ADR provision of the Revenue Act of 1971 and the current deduction for income tax purposes of the cost of removal of retired assets.

Deferred income taxes are not provided for the income tax reductions resulting from the deduction of certain taxes, pension costs, and interest which are capitalized for financial reporting purposes.

Investment tax credit of \$1,163,000 and \$961,000 earned in 1976 and 1975, respectively, has been deferred in the accompanying financial statements and will be amortized to income over the useful property life of the related assets.

(h) Net income per average share

Net income per average common share is based on the weighted average number of common shares outstanding during each year.

2. Transactions with related parties

At December 31, 1976 and 1975, approximately 80% of T.U.'s outstanding common stock was beneficially owned by Pacific Power & Light Company (Pacific). The following is a summary of transactions with Pacific:

(a) Management services

Pacific provides certain management and other services, at cost, to the Company under a management services agreement. Billings under this management services agreement totaled \$232,234 in 1976 and \$265,215 in 1975.

(b) Temporary cash investments

At December 31, 1976 and 1975, temporary cash investments included \$5,400,000 and \$4,100,000, respectively, of short-term advances to Pacific. These advances were made under an agreement providing for the temporary investment of excess cash at the prime commercial rate of interest. Interest income from investments made under this agreement was recorded as follows:

	1976	1975
Parent operations	\$ 409,583	\$ 298,797
Other income	—	71,830
	<u>\$ 409,583</u>	<u>\$ 370,627</u>

(c) Income taxes

The Company will join with Pacific in filing a consolidated federal income tax return. The federal income tax is allocated to the Company on the basis of its filing a separate consolidated federal income tax return.

3. Long-term debt

Long-term debt at December 31, 1976 and 1975 consisted of the following:

	1976	1975
2%-8% First Mortgage notes payable to Rural Electrification Administration and Rural Telephone Bank, maturities 1990-2009	\$ 1,991,278	\$ 1,734,411
5%-10¼% First Mortgage notes and bonds, maturities through 1998	19,027,135	20,162,013
7¾% Second Mortgage note, due 1980	11,000,000	11,000,000
5¾%-9¾% Unsecured notes, maturities 1978-2007	14,671,982	13,528,374
	<u>46,690,395</u>	<u>46,424,798</u>
Less current maturities .	<u>1,484,288</u>	<u>1,550,932</u>
	<u>\$45,206,107</u>	<u>\$44,873,866</u>

Substantially all of the telephone plant in service is pledged as collateral securing portions of the long-term debt. Certain of the loan agreements contain provisions, among others, restricting the payment of cash dividends, and one loan agreement, in addition to restricting cash dividends, contains limitations on purchases or redemptions of T.U.'s stock. Retained earnings of \$7,993,000 are not restricted at December 31, 1976.

Total long-term debt maturing annually within each of the four years after December 31, 1977 is as follows:

1978	\$ 1,739,306	1980	\$12,710,549
1979	\$ 1,800,529	1981	\$ 1,639,315

4. Shareholders' equity

Under the Employee Stock Option Plan, approved by shareholders in 1973, options to purchase 100,000 shares of common stock at fair market value at date of grant may be granted to certain key employees. At December 31, 1976, no options had been granted under the plan.

5. Parent operations

Parent operations of T.U. are summarized as follows:

	1976	1975
Interest income:		
From subsidiaries	\$ 156,224	\$ 42,500
Other—principally on temporary cash investments (Note 2)	409,583	361,688
	<u>565,807</u>	<u>404,188</u>
Interest expense:		
To subsidiaries	311,374	272,832
Other—principally on long-term debt	729,918	744,441
	<u>1,041,292</u>	<u>1,017,273</u>
Federal income tax (credit):		
Federal income taxes . .	(247,000)	(325,000)
Deferred federal income taxes	(3,000)	12,000
Net deferred investment tax credit	1,000	(3,000)
	<u>(249,000)</u>	<u>(316,000)</u>
Other expense—net	44,176	51,442
	<u>\$ 270,661</u>	<u>\$ 348,527</u>

6. Federal income taxes

Deferred income taxes result from timing differences in the recognition of expense for tax and financial statement purposes. The tax effects of these differences are as follows:

	1976	1975
Excess of tax over book depreciation . .	\$ 1,003,000	\$ 907,000
Cost of removal of retired assets deducted for tax purposes	102,000	106,000
	<u>\$ 1,105,000</u>	<u>\$ 1,013,000</u>

The Company's effective federal income tax rate was 47.2% in 1976 and 46.9% in 1975. The differences between these effective rates and the 48% federal income tax statutory rate are attributable to the following:

	1976	1975
Interest, taxes and pensions capitalized .	2.8%	4.0%
Amortization of invest- ment tax credit	2.1	1.6
Other	(4.1)	(4.5)
	<u>.8%</u>	<u>1.1%</u>

7. Commitments

Expenditures in connection with the Company's construction program will approximate \$12,050,000 in 1977. Cash now temporarily invested (Note 2) will be utilized in connection with the construction expenditures.

Total rental expenses for 1976 and 1975 are as follows:

	1976	1975
Pole contacts	\$ 294,543	\$ 276,141
Other, including short-term rentals .	148,564	144,877
	<u>\$ 443,107</u>	<u>\$ 421,018</u>

Commitments under several minor long-term leases are not material to results of operations or financial position.

8. Quarterly financial data

Summarized quarterly financial data (unaudited) for 1976 is as follows:

	Three Months ended			
	March 31	June 30	Sept. 30	Dec. 31
Operating revenues . .	<u>\$7,832,031</u>	<u>\$7,919,219</u>	<u>\$8,035,810</u>	<u>\$8,460,805</u>
Operating income . . .	<u>\$1,790,709</u>	<u>\$1,806,013</u>	<u>\$1,852,379</u>	<u>\$2,098,884</u>
Net income .	<u>\$1,032,802</u>	<u>\$1,102,024</u>	<u>\$1,203,349</u>	<u>\$1,452,771</u>
Net income per common share	<u>\$.22</u>	<u>\$.23</u>	<u>\$.25</u>	<u>\$.31</u>

See the Summary of Operations and Management's Discussion and Analysis of the Summary of Operations for additional information with respect to the year ended December 31, 1976.

9. Asset replacement cost

The impact of the inflation experienced in recent years has resulted in replacement costs (unaudited) of telephone plant that are significantly greater than the historical costs of such assets reported in the accompanying consolidated financial statements. The Company's ability to maintain its investment in telephone plant in the future will be contingent upon its ability to finance the needed additions. This, in turn, will depend primarily on the Company's ability to obtain adequate and timely rate relief.

The Company's annual report to the Securities and Exchange Commission on Form 10-K contains additional information with respect to estimated asset replacement cost at December 31, 1976.

Accountants' Opinion

To the Directors and Shareholders
of Telephone Utilities, Inc.:

We have examined the consolidated balance sheet of Telephone Utilities, Inc. and subsidiaries as of December 31, 1976 and 1975 and the related consolidated statements of income, retained earnings, capital in excess of par value, and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the above-mentioned consolidated financial statements present fairly the financial position of Telephone Utilities, Inc. and subsidiaries at December 31, 1976 and 1975 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Portland, Oregon
January 28, 1977

Haskins & Sells

Officers and Management

A. M. GLEASON

President and Chief
Executive Officer

LEWIS C. NEACE, M.D.

Senior Vice President

VERN K. DUNHAM

Vice President

JOHN H. GEIGER

Vice President

ROBERT E. UNRUH

Vice President

CHARLES C. ADAMS

Controller

BRIAN M. WIRKKALA

Secretary-Treasurer

C. E. PETERSON

Operations Manager

JAMES E. AYDELOTT

Chief Engineer

GERARD K. DRUMMOND

Assistant Secretary

MARGARET WANN

Assistant Secretary

MARVA J. WIRKKALA

Assistant Treasurer

Directors

A. M. GLEASON

President of the Company

LEWIS C. NEACE, M.D.

Senior Vice President
of the Company
and Practicing Physician

JOHN H. GEIGER

Vice President of the Company and
Vice President-Finance of
Pacific Power & Light Company
Portland, Oregon

B. LAMAR GAINES

Retired
North Bend, Washington

R. C. REEVES

President
Reeves Clothing Co.
Lebanon, Oregon;
retail clothing store

CARL J. RONNING

Vice President and Manager,
Trust Operations
Title Insurance and Trust Company
Los Angeles, California;
title insurance and trust company

SIDNEY R. SNYDER

President
Sid's Super Market, Inc.
Seaview, Washington;
retail grocer

HUBERT A. TONDREAU

Assistant Vice President
Standard Insurance Company
Portland, Oregon;
life insurance company

Common Stock Telephone Utilities, Inc.

Range of Bid and Asked Prices for Quarters Ended

	Bid		Asked	
	High	Low	High	Low
March 31, 1975	6½	3¼	7½	4¼
June 30, 1975	5½	4½	6½	5½
September 30, 1975	5¾	5	6¾	6
December 31, 1975	5¼	4¼	6¼	5¼
March 31, 1976	6¼	4¼	7¼	5½
June 30, 1976	6	5	7	6
September 30, 1976	6	4¾	7	5¾
December 31, 1976	6½	5½	7½	6¾

Cash dividend payable dates:

Per Share

February 2, 1976	\$.07
May 3, 1976	\$.07
August 2, 1976	\$.07
November 1, 1976	\$.07

\$.08 quarterly cash dividend declared December 17, 1976 payable February 7, 1977

Common stock dividend 1975—5%

Stock is traded in National OTC Market NASDAQ—TPHN

Transfer Agent and Registrar

First National Bank of Oregon
Portland, Oregon

General Counsel

Rives, Bonyhadi, Drummond & Smith
Portland, Oregon

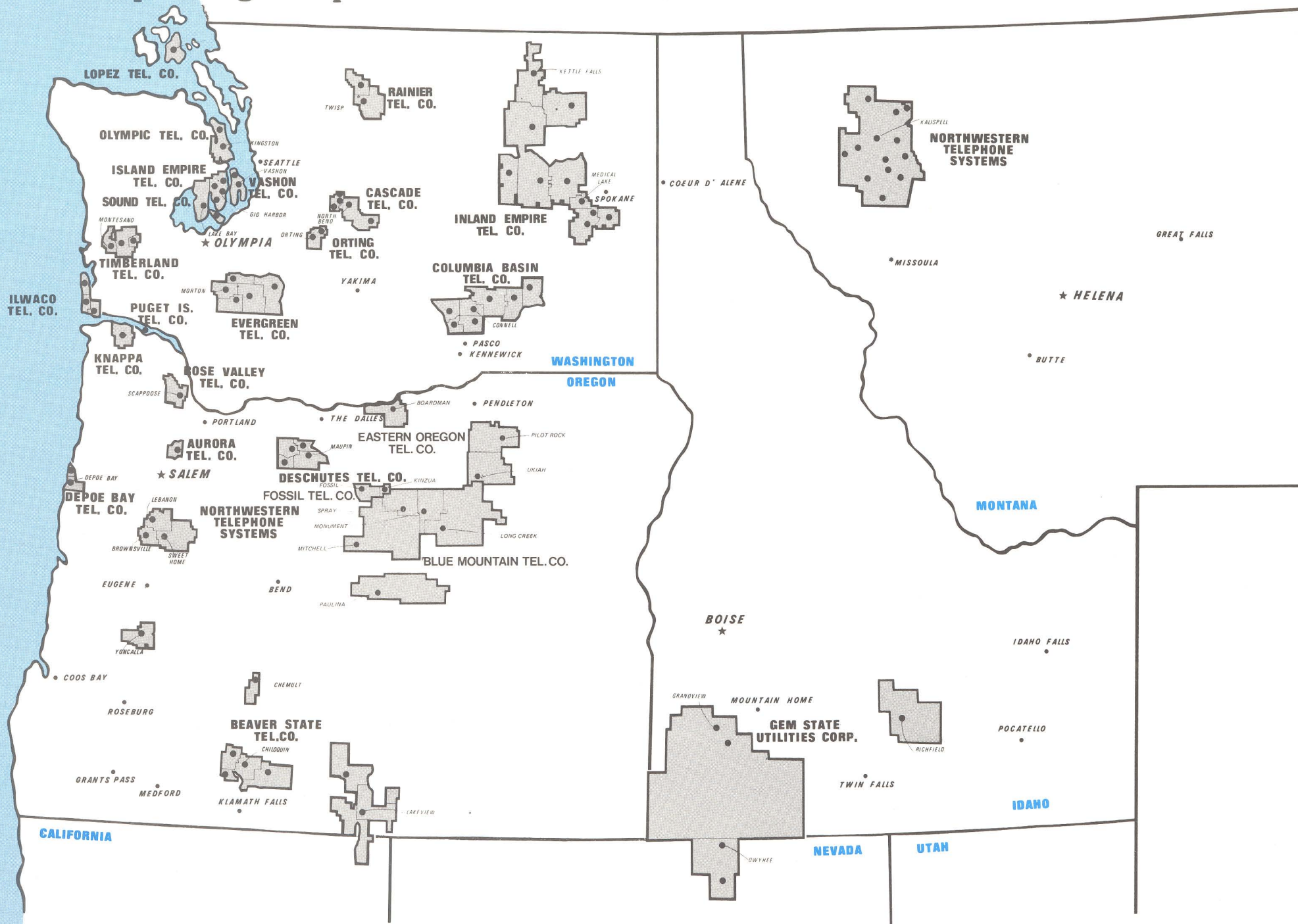
Special Counsel

Bogle & Gates
Seattle, Washington

Auditors

Haskins & Sells
Portland, Oregon

Operating Companies and Service Area



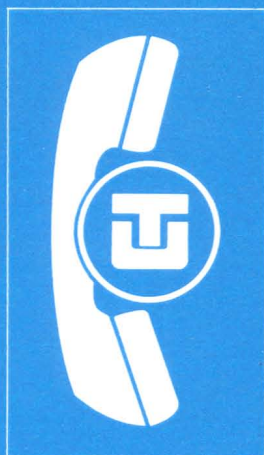
1976 Highlights

		1976	1975
THE SHAREHOLDER	Net income applicable to common stock	\$ 4,760,473	\$ 4,180,192
	Average shares outstanding	4,724,487	4,728,079
	Net income per average common share	\$1.01	\$.88
	Total shareholders' equity	\$ 48,561,933	\$ 45,171,505
THE COMPANY	Operating revenues	\$ 32,247,865	\$ 28,835,866
	Working capital from operations	\$ 12,672,205	\$ 11,207,837
	Total assets; end of year	\$112,771,549	\$103,962,674
	Telephone plant in service; end of year	\$110,709,902	\$100,407,283
	Telephones in service; end of year	138,625	125,402
THE EMPLOYEE	Total employees; end of year	618	585
	Total wages paid	\$ 7,990,728	\$ 6,872,651

46c	70c	78c	88c	\$1.01
1972	1973	1974	1975	1976

The Company will furnish to Shareholders upon written request, without charge, a copy of its annual report on Form 10-K for the Company's most recent fiscal year. The Form 10-K contains more detailed statistical and financial information than is included in the Annual Report to Shareholders. If you wish a copy of the Form 10-K, you may address your request to Mr. Brian M. Wirkkala, Secretary, Telephone Utilities, Inc., Ilwaco, Washington 98624.

The Annual Meeting of Shareholders of Telephone Utilities, Inc. will be held at 2:00 p.m., Pacific Daylight Time, on Monday, April 25, 1977 at the American Legion Hall, Ilwaco, Washington 98624



Telephone Utilities, Inc.

To Our Shareholders:

We are particularly pleased to report that 1976 was a year of continued progress in which we exceeded a major earnings milestone. Our net income per average common share passed the \$1.00 level reaching \$1.01 per share, up 14.8 percent from the \$.88 level achieved in 1975. A glance at the five-year summary of operations on the following page will dramatize the significance of this accomplishment. Our earnings have increased significantly each year and more than doubled in the four years beginning in 1973 when the Company was reconstituted under the present management. The compound earnings growth ratio during that four-year period exceeds 19 percent. Also, 1976 saw gross operating revenues achieve a new record level of \$32,247,865 up 11.8 percent from 1975.

The economic health and diversity of our service territory were again evident during the year. Our internal station growth rate which grew at 7 percent in spite of the 1974-1975 recession increased to approximately 9 percent, a figure double the national average. This internal growth, along with the acquisition of the Eastern Oregon Telephone Company which serves areas in and around Boardman and Pilot Rock, Oregon, brought the number of stations served to 138,625. Increased operating efficiencies allowed us to serve this expanded number of stations without significantly increasing the employee work force. As a result, the number of telephones served per employee increased from 214 to 224, a figure which compares favorably within the industry.

Our 1976 construction program was designed to provide our subscribers with better service as well as to meet the demands of increased numbers of telephones served. We completed a number of major construction projects during the year, including an expansion of the computerized ticketing system in Gig Harbor, Washington, the provision of Direct Distance Dialing through electronic toll ticketing in both the Ilwaco and Evergreen companies, expansion of our microwave systems in both the Northwestern Telephone—Oregon and Beaver State properties and placing in service of an automated operator service component of our electronic switching system in Kalispell, Montana. All of these projects are functioning well. The new operator service system, which is described in more detail elsewhere in this report, allows us to provide a high level of operator service to our subscribers in the Montana property and is a source of considerable pride to our Company. The addition of these projects and other system improvements provided the capacity to meet the demand for increased toll usage, an increase of 12.7 percent over the preceding year.

The entire 1976 construction program was financed from internally generated funds for the third consecutive year and we expect to meet our 1977 construction budget of \$12,050,000 without outside financing.

We currently have no rate applications pending and do not anticipate filing for any general rate increases in states other than Montana. As a result of the major service improvement projects recently completed in Montana we are now experiencing a less than adequate return on investment and expect to request rate relief in that state in 1977. Because of expected regulatory lag we do not anticipate any impact from this filing on 1977 results.

We continue to contact other independent telephone companies in and around the general area served by the Company seeking acquisition opportunities. Although none have been finalized as of this writing, we continue to believe that the acquisition of other properties is a viable method to expand the investment opportunity of the Company and thereby enhance its long-term growth prospects.

In December 1976 the Board of Directors increased the annual dividend rate 14 percent from \$.28 per share to \$.32 per share, payable quarterly commencing with payment on February 7, 1977. Although the Board has not yet established a percentage payout objective to be applied to future earnings, the current dividend will be reviewed as soon as further earnings improvement warrants.

Please read the more detailed information and accompanying financial statements. If you care to comment or have questions about the material herein or other matters concerning the Company, please advise.

Sincerely,



A. M. Gleason
President

Telephone Utilities, Inc.
SUMMARY OF OPERATIONS

Years ended December 31,

	1976	1975	1974	1973	1972
Operating revenues	\$32,247,865	\$28,835,866	\$25,621,214	\$22,974,330	\$18,692,367
Operating expenses, other than federal income taxes	20,102,880	17,869,546	15,434,263	13,284,042	12,538,807
Federal income taxes	4,597,000	4,089,000	3,640,000	3,180,516	1,169,937
Total operating expenses	24,699,880	21,958,546	19,074,263	16,464,558	13,708,744
Operating income	7,547,985	6,877,320	6,546,951	6,509,772	4,983,623
Other income	510,001	725,347	743,961	541,957	427,807
Interest expense	2,932,483	2,985,781	3,188,204	3,218,376	2,517,917
Minority interest in net income and preferred stock dividends of subsidiaries	63,896	57,694	52,012	58,446	45,425
Income from telephone operations	5,061,607	4,559,192	4,050,696	3,774,907	2,848,088
Parent operations—interest and expenses—net	270,661	348,527	318,684	456,312	678,471
Net income	4,790,946	4,210,665	3,732,012	3,318,595	2,169,617
Preferred stock dividends	30,473	30,473	30,473	31,216	31,290
Net income applicable to common stock	\$ 4,760,473	\$ 4,180,192	\$ 3,701,539	\$ 3,287,379	\$ 2,138,327
Average number of common shares outstanding	4,724,487	4,728,079	4,728,079	4,728,079	4,682,991
Net income per average common share	\$1.01	\$.88	\$.78	\$.70	\$.46

Management's Discussion and Analysis of the Summary of Operations

The summary of operations includes the operations of Telephone Utilities, Inc. (T. U.) and its subsidiaries (Company), all majority-owned.

Operating revenues for 1976 and 1975 increased principally as a result of continuing improvements in toll settlements with connecting companies. The majority of the Company's subsidiaries are on the cost basis for toll settlements, which provides for the recovery of the costs of furnishing toll service plus a return on the investment in plant utilized in furnishing such toll service. In addition, local service revenue increased because of an increase in the number of subscribers served, increased directory advertising revenues, and in 1975, because of rate increases in certain service areas.

Operating expenses, other than federal income taxes for 1976 and 1975, increased due to: (a) generally higher labor and material costs; (b) increased maintenance expense resulting from expanded central office and outside plant maintenance programs and, in 1975, expenses related to the placing in service of a major central office construction project; (c) increased depreciation expense resulting from the large plant additions completed in recent years and an increase in the composite depreciation rates to 5.9% in 1976 and 1975 as compared with 5.8% in 1974; and (d) in 1975, increased operating taxes

expense, principally as a result of higher property taxes. A significant portion of operating expenses is included as cost of furnishing toll service and is recovered as revenues through the toll settlement procedure.

Federal income tax expense for 1976 and 1975 increased principally because of higher income levels.

Other income includes the allowance for funds used during construction, a non cash item, and interest income. The allowance for funds used during construction represents the cost of the funds used for construction of telephone plant and, accordingly, fluctuates with the increases and decreases of the construction program. The decreased amount for 1976 is due to the lower average amount of construction work in progress during the year. Interest income, which results from the intercompany short-term investment of excess cash by subsidiaries, decreased in 1976 as a result of average amounts invested and a reduction of the average rate of interest earned.

Parent operations consists of the interest income earned by T. U.'s short-term investments of excess cash, the interest and other expenses of T. U. and the related tax effect of these transactions. Interest income for 1976 and 1975 increased as a result of greater average amounts invested. Interest for 1976 and 1975 increased as a result of the issuance of additional long-term debt and increased short-term borrowings from subsidiaries.

The Company

Telephone Utilities, Inc. is a telephone holding company whose subsidiary operating companies serve 138,625 telephones located principally in Washington, Montana and Oregon and to a lesser extent in Idaho, Nevada and California. All of the operating companies are subject to the jurisdiction of regulatory agencies in the states in which they operate. In addition to conventional telephone service, a subsidiary operates an Automatic Voice Network (Autovon) switching center under a contract with the government which will terminate in 1980. This contract is subject to earlier cancellation for the convenience of the government in which case the unrecovered costs would be reimbursed by the government.

During 1976 TU purchased Eastern Oregon Telephone Company which serves a total of 2,261 stations through three exchanges. No other acquisitions of telephone properties were pending at year-end; however, the Company continues to actively pursue such acquisitions as the opportunities present themselves.

The telephone subsidiaries have been organized into four operating divisions which have been established essentially along geographical lines. This has permitted the achievement of significant operating efficiencies and cost savings. Plans are being implemented to merge the companies operating in each state into larger operating companies. These mergers, which will require the approval of lenders and regulatory bodies, will permit achievement of further cost reductions. The consolidation will also reduce the number of separate rate cases required to maintain a fair rate of return on invested capital.

Construction and Service Improvements

During 1976 TU placed in service additions totaling \$12,615,526 to expand the capacity of our plant facilities and to provide service improvements to our subscribers.

There were several major construction projects completed during the year including the completion of traffic operator positions (TOPS) associated with the electronic switching system in Kalispell, Montana. In addition, the economically inefficient small operator service functions in the Ilwaco Telephone Company at Long Beach, Washington and the Evergreen Telephone Company at Morton, Washington, were eliminated and Direct Distance Dialing equipment was provided at each of those two locations. The introduction of DDD to these two properties has been well received and was a contributing factor to our increases in toll volumes.

Another major project was the installation of additional computer capacity to our electronic DDD ticketing system in the Island Empire company in Gig Harbor, Washington.

Other construction activity saw additions to the Beaver State Telephone Company microwave system in and near Lakeview, Oregon, and a replacement of the Northwestern Telephone Systems' microwave system in the Lebanon, Oregon area as well as a variety of local plant improvement projects designed to meet increased toll calling, requests for service improvements and the addition of new subscribers throughout our service territory.

We expect 1977 construction and service improvement programs to require expenditures of \$12,050,000. This money will be required for additions to the Kalispell, Montana electronic switching system and a variety of central office and outside plant projects throughout the entire Company. This construction program is expected to be funded through internally generated funds and existing cash reserves.

Revenue and Rate Activities

1976 saw no significant rate increase activity. The revenue deficiencies that were expected to develop in 1976 were significantly offset by increased earnings from our toll settlement arrangements and growth in local revenues. Currently there are no rate increases pending although we are actively preparing a rate increase request covering the Northwestern Telephone Systems property in Kalispell, Montana. During the past several years a significant number of service improvement projects have been completed without corresponding revenue increases. As a result, our rate of return in that property is not currently adequate to meet our requirements and we expect to file an application for substantial rate relief in 1977. Although the Montana Public Service Commission has no stated time period during which it must act on our application, it has announced an internal objective of concluding action by nine months from the date of filing. With our present timing and the resulting period required for processing by the agency, no impact is anticipated on 1977 results.

During 1976 we experienced a 12.7 percent increase in toll messages. This compares with an increase of 10.7 percent in 1975 and 8.4 percent in 1974. This continued increase in toll volumes contributes significantly to meeting our revenue requirements through enhanced toll settlements with connecting companies. During 1976 the Company also benefited through increased rates of return earned by the majority of our connecting companies which are shared with us through the workings of the toll settlement process.

Employees and Labor Relations

At December 31, 1976 the Company had 618 full-time employees compared to 585 at year-end 1975. Because the number of employees added increased at a lesser rate than the number of telephones served, the number of stations served per employee, a common industry measure of efficiency, improved from 214 in 1975 to 224 at year-end 1976.

Slightly over 50 percent of our employees are members of either the International Brotherhood of Electrical Workers or Communication Workers of America, both AFL-CIO affiliates, and are represented through a total of four different bargaining units. Each of the contracts with those units expire in the latter part of 1977.

In addition, we have a working agreement with approximately 10 percent of our employees who represent themselves through an elected committee which also expires in the fourth quarter of 1977.

Contracts covering employees in the bulk of the telephone industry in the nation expire during mid-1977. We expect to begin negotiations with our employee groups soon after conclusion of the bargaining on the nationwide contracts by the larger companies in the industry. We would be hopeful that our contracts can be settled on whatever pattern is established in those nation-wide settlements since we remain committed to providing wages and benefits for both union and non-union employees comparable to others in our industry.

Continuation of Service Improvement . . . TOPS



The old operator positions

With the placing in operation of the final phase of electronic switching equipment in Kalispell, we have marked an end to an era at our Kalispell switching center. The familiar manual cord board operator system was phased out in May of 1976 and the new computer-controlled **Toll Operator Positioning System (TOPS)** took over. The new system, the first of its kind, provides for marked improvement in service for our subscribers while reducing our operating costs. Typically, the new system is 40-50 percent more efficient than the older manual type. Because of the computer environment, future growth and changing requirements are very easy to implement, providing our company with the ability to meet any of our foreseeable needs quickly and economically. This completes a project that was started in the spring of 1973 to provide a new modern switching system in Kalispell, to provide for existing and future needs of the Montana operation.



New computer controlled TOPS



A single operator position

Telephone Utilities, Inc.**CONSOLIDATED STATEMENT OF INCOME**

Years ended December 31, 1976 and 1975

1976**1975**

Operating revenues:		
Local service	\$ 9,749,997	\$ 8,809,315
Toll service	20,025,997	17,849,858
Government communication service	1,249,777	1,265,519
Miscellaneous	1,222,094	911,174
Total operating revenues	32,247,865	28,835,866
Operating expenses:		
Maintenance	5,839,561	4,816,536
Depreciation (Note 1)	5,785,425	5,232,247
Traffic	818,667	949,423
Commercial, administrative and other	5,024,198	4,278,865
Taxes, other than federal income taxes	2,635,029	2,592,475
Federal income taxes (Notes 1 and 6)	2,522,000	2,251,000
Deferred federal income taxes (Notes 1 and 6)	1,108,000	1,001,000
Net deferred investment tax credit (Notes 1 and 6)	967,000	837,000
Total operating expenses	24,699,880	21,958,546
Operating income	7,547,985	6,877,320
Other income:		
Allowance for funds used during construction (Note 1)	273,058	378,505
Other, including interest income (Notes 2 and 5)	236,943	346,842
	510,001	725,347
Interest expense—principally on long-term debt (Note 5)	2,932,483	2,985,781
Minority interest in net income and preferred stock dividends of subsidiaries	63,896	57,694
Income from telephone operations	5,061,607	4,559,192
Parent operations—interest and expenses—net (Note 5)	270,661	348,527
Net income	4,790,946	4,210,665
Preferred stock dividends	30,473	30,473
Net income applicable to common stock	\$ 4,760,473	\$ 4,180,192
Net income per average common share (Note 1)	\$1.01	\$.88

See accompanying notes.