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PACIFIC ANNUAL REPORT
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Telephone Utilities, Inc. 1977 Annual Report

file: Pacific
Telecom,
Inc

Highlights

		1977	1976	Percent Increase
The Shareholder	Net income applicable to common stock	\$ 5,775,102	\$ 4,760,473	21
	Average shares outstanding	4,727,985	4,724,487	—
	Net income per common share	\$1.22	\$1.01	21
	Total shareholders' equity	\$ 53,133,641	\$ 48,561,933	9
The Company	Operating revenues	\$ 37,155,363	\$ 32,247,865	15
	Working capital from operations	\$ 14,756,197	\$ 12,672,205	16
	Telephone plant in service, end of year	\$121,067,841	\$110,709,902	9
	Telephones, end of year	155,192	138,625	12
The Employee	Total employees, end of year	659	618	7
	Total wages paid	\$ 9,657,461	\$ 7,990,728	21

To Our Shareholders:

The year 1977 was one of rapid development in virtually all aspects of the Company.

Net income per common share increased by 21 percent to \$1.22 compared to \$1.01 in 1976.

This fifth consecutive year of record earnings results in a compound growth rate of approximately 19 percent for the period, higher than any other comparably sized telephone company.

The level of general business activity was very high throughout our entire service area during 1977. Our internal growth rate in stations exceeded 10 percent, more than double the national average for the industry. The acquisition at mid-year of the Creswell Telephone Company located near Eugene, Oregon brought the total number of stations served at the end of 1977 to 155,192, an overall increase of 12 percent over 1976.

Our gross operating revenue exceeded \$37 million, a 15 percent increase from the preceding year. Increased toll usage, station growth and acquisitions accounted for this growth. The 1977 construction budget was fully expended in order to meet the service demands of our subscribers. The number of service improvement projects and expenditures to serve the communication requirements of new subscribers impacted every area of the Company's operations. We are pleased to report that the Company successfully met the service demands placed upon it while continuing to show a modest increase in the number of telephones served per employee.



Although growth and acquisitions increased the work force by 41 employees, productivity continued to improve as evidenced by the number of telephones served per employee which increased to 235 from 224.

The entire 1977 construction program was financed from internally generated funds, and we ended the year with a strong cash position. With our growth rate continuing at high levels, our 1978 construction budget totals \$16,500,000, the largest in the Company's history.

Included in our construction program is a commitment to purchase three electronic central offices employing digital switching technology. These switching systems represent the latest in the evolution of telephone central offices. This equipment is readily expandable to meet future growth and promises significant savings in labor and building requirements.

The hearings on our Montana rate increase application were concluded by the Montana Public Service Commission on February 3, 1978. The Commission's decision is due by the end of March, 1978. No other rate applications are pending at this time.

We continue to seek acquisitions that can contribute to our profitability, but none is currently pending.

In view of the growth in earnings, the Board of Directors increased the annual dividend rate 12½ percent to \$.36 per share payable quarterly commencing with the payment on November 28, 1977.

Please review the other more detailed information and accompanying financial statements which are contained in this report. If you continue to have questions or care to comment on any matters concerning the Company, please advise.

A handwritten signature in blue ink that reads "A. M. Gleason".

A. M. Gleason
President

Telephone Utilities, Inc.
SUMMARY OF OPERATIONS

Years ended December 31,	1977	1976	1975	1974	1973
Operating revenues	\$37,155,363	\$32,247,865	\$28,835,866	\$25,621,214	\$22,974,330
Operating expenses, other than federal income taxes	22,978,085	20,102,880	17,869,546	15,434,263	13,284,042
Federal income taxes	5,523,649	4,597,000	4,089,000	3,640,000	3,180,516
Total operating expenses	28,501,734	24,699,880	21,958,546	19,074,263	16,464,558
Operating income	8,653,629	7,547,985	6,877,320	6,546,951	6,509,772
Other income	290,597	510,001	725,347	743,961	541,957
Interest expense	2,742,470	2,932,483	2,985,781	3,188,204	3,218,376
Minority interest in net income and preferred stock dividends of subsidiaries	51,328	63,896	57,694	52,012	58,446
Income from telephone operations	6,150,428	5,061,607	4,559,192	4,050,696	3,774,907
Parent operations—interest and expenses—net	344,853	270,661	348,527	318,684	456,312
Net income	5,805,575	4,790,946	4,210,665	3,732,012	3,318,595
Preferred stock dividends	30,473	30,473	30,473	30,473	31,216
Net income applicable to common stock	\$ 5,775,102	\$ 4,760,473	\$ 4,180,192	\$ 3,701,539	\$ 3,287,379
Average number of common shares outstanding	4,727,985	4,724,487	4,728,079	4,728,079	4,728,079
Net income per common share	\$1.22	\$1.01	\$.88	\$.78	\$.70

Management's Discussion and Analysis of the Summary of Operations

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

Operating revenues increased in 1977 and 1976 due to growth both in local and toll service revenues. Toll service revenue increased 16.8% in 1977 and 12.2% in 1976 due to increased toll calling and an increase in the number of subscribers.

Local Service revenue increased 13% in 1977 and 10% in 1976, because of growth in the number of subscribers, both internally and through acquisition. The 1977 figures include the operations of Eastern Oregon Telephone Company, acquired in November, 1976, and six months of operations of Creswell Telephone Company, acquired in June, 1977. Operating revenues from Eastern Oregon and Creswell represent 2.8% of total 1977 operating revenues.

The majority of the Company's subsidiaries are on the cost basis for toll settlements which provides for the recovery of the cost of providing toll service plus a return on the investment in plant utilized in furnishing such toll

service.

Operating expenses, other than federal income taxes increased in 1977 and 1976 due to (a) generally higher labor and material costs as well as the acquisitions mentioned above, (b) increased depreciation expense resulting from the large plant additions completed in recent years and an increase in the composite depreciation rate from 5.9% to 6.0% in 1977 and (c) in 1977, higher taxes other than federal income taxes, principally due to increased ad valorem taxes as a result of higher tax rates. A significant portion of operating expenses is included as cost of furnishing toll service and is recovered as revenue through the toll settlement procedure.

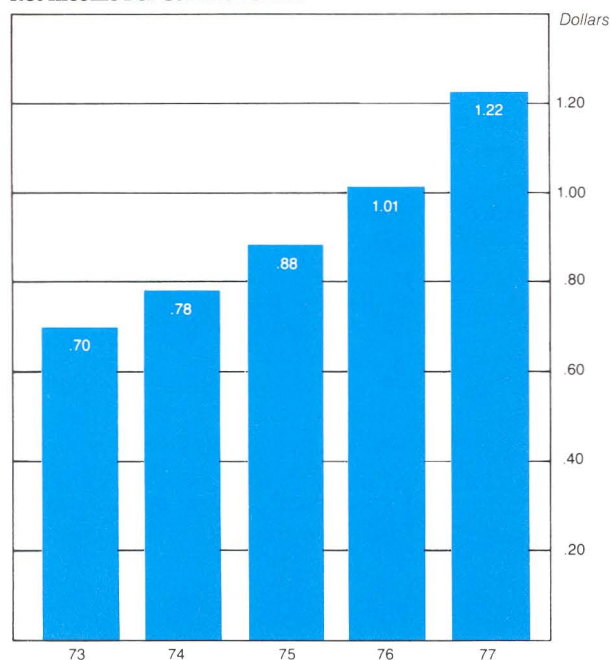
Federal income tax expense for 1977 and 1976 increased principally because of higher income levels.

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

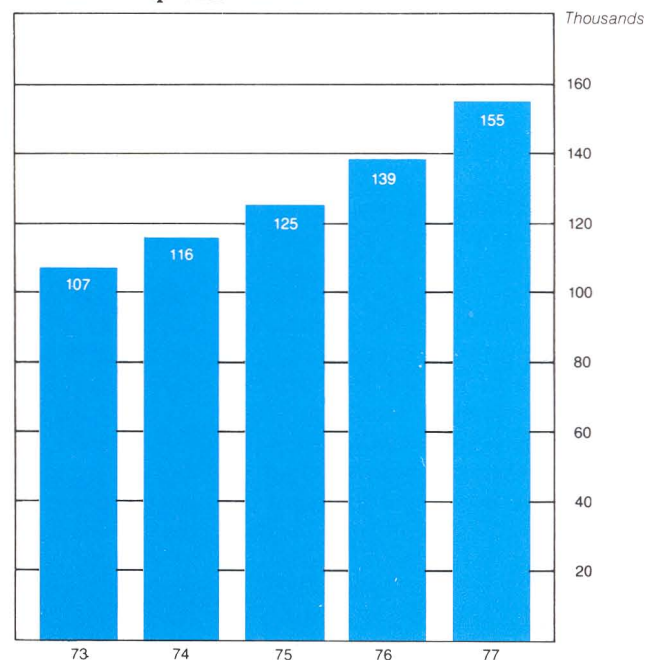
of the construction program and the duration of construction projects. The decreased amounts for 1977 and 1976 is the result of a smaller average amount of construction work in progress due to construction projects of shorter duration. Interest income, which results from intercompany short-term investment of excess cash by subsidiaries, decreased in 1977 and 1976 as a result of reductions in average amounts invested.

Parent operations consist of the interest income earned by TU's short-term investments of excess cash, the interest and other expenses of TU and the related tax effect of these transactions. (See Note 5 of Notes to Consolidated Financial Statements.) Interest income increased in 1976 as a result of a greater average amount invested and accordingly decreased in 1977 as the average amount invested declined. Interest expense increased in 1976 principally due to increased short-term borrowings from subsidiaries and decreased in 1977 as those short-term borrowings decreased.

Net Income Per Common Share



Number of Telephones At December 31



The Company

Telephone Utilities, Inc. is a telephone holding company whose subsidiary operating companies serve 155,192 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, located in North Bend, Washington, 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.

TU Service Company, located in Portland, Oregon, provides centralized purchasing and warehouse facilities for the Company's operating subsidiaries.

During 1977 TU purchased Creswell Telephone Company which serves a total of 2,348 stations through one exchange located approximately 10 miles from Eugene, Oregon. No other acquisitions of telephone properties were pending at year-end; however, the Company continues to actively pursue such acquisitions as opportunities occur.

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. We are taking steps to

merge the companies operating in each state into larger operating companies which should provide 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. Applications to accomplish these mergers in Oregon are pending before the Oregon Public Utility Commissioner and we expect to file similar applications in Washington during 1978.

Construction and Service Improvement

A total of \$14,002,975 was invested during 1977 to provide for new service requirements and a variety of service improvements for our subscribers. Although these projects ranged in scope from expansions of toll network and microwave facilities to the introduction of software controlled Private Branch Exchanges, none of the individual work orders exceeded \$250,000. The general level of growth throughout our service area imposed a very heavy volume of smaller construction and improvement projects on the Company.

With the level of activity continuing into 1978, it has been necessary to budget a total of \$16,500,000 for new and expanded service capability. This construction budget is the largest in the Company's history; however, it has been determined to be absolutely necessary if the Company is to keep pace with the rate of growth and our subscribers' seemingly insatiable demands for higher grades of service.

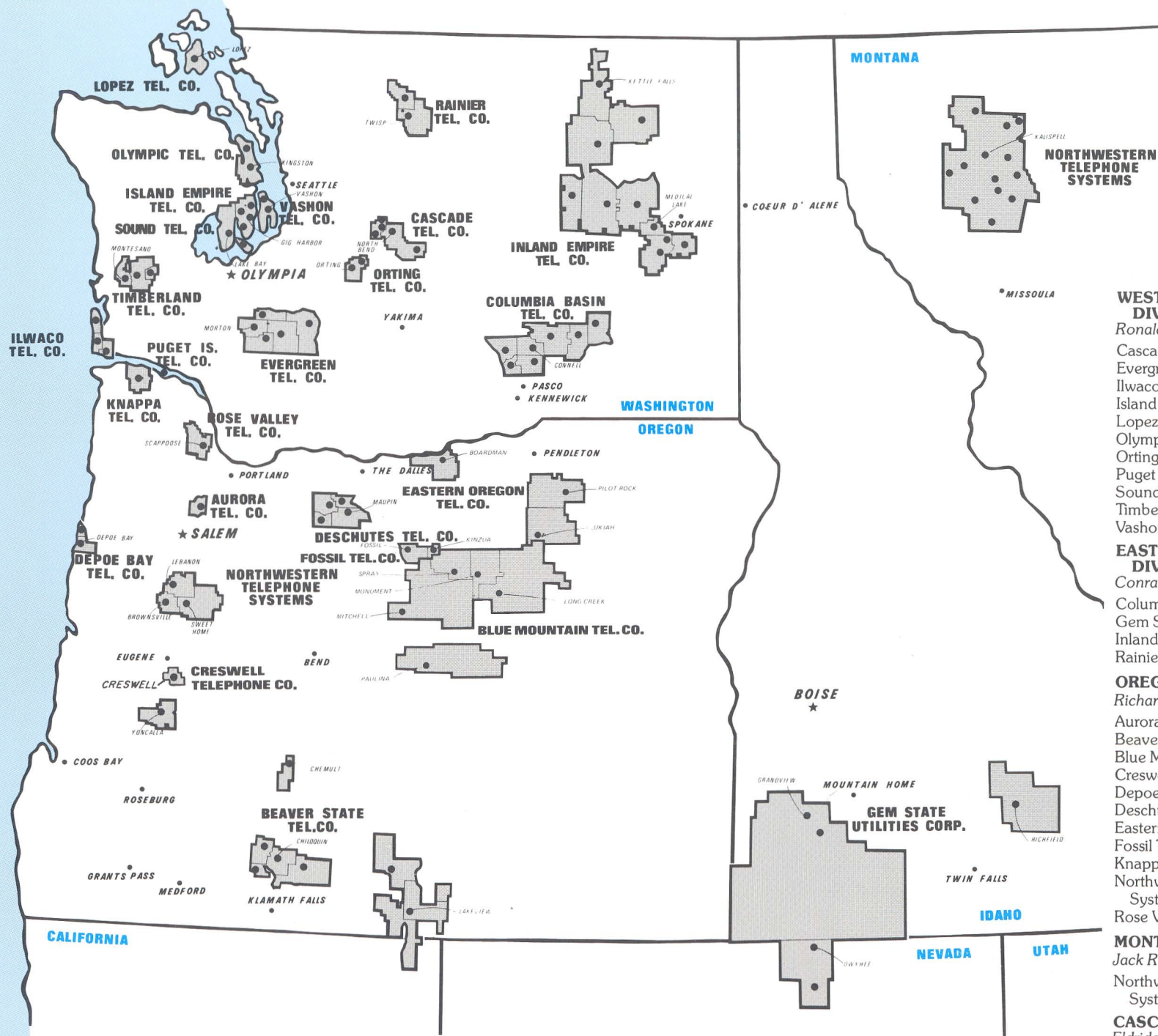
During 1978 construction will begin on three electronic central office switches employing digital switching technology. These switches will be installed in Elma, Washington; Kingston, Washington; and Boardman, Oregon. Each of these locations is experiencing rapid growth and service demands beyond the capacity of the existing older style switching equipment. The digital switch employs technology that has been thoroughly proven in communication and computer applications. The promises of the digital switch are space savings, maintenance labor savings, ease of expansion and provision of current and proposed special features, as well as very competitive pricing compared to prior switching systems.

The 1978 construction program continues a trend toward underground cable plant in much of our service area, often at costs below that of overhead construction. Another trend rapidly developing is the application of electronic transmission equipment to

existing outside cable plant to either avoid or defer replacement of small capacity cables. Historically, electronics have been heavily used in toll plant applications; however, they are now proving to be very cost effective in increasing the capacity of our distribution system.

To date the Company has seen little impact from the Federal Communication Commission's rules allowing the direct connection of subscriber owned equipment to our facilities. We expect to be competitive for this type of business and will aggressively respond to the increased competition that will no doubt ensue.

We expect to fund the bulk of our 1978 budget from internally generated funds and cash currently on hand. Such borrowings as may be necessary will be of small amount and can be provided by short-term funds from banks or others.



Operating Companies and Service Area

Revenue and Rate Activities

Last year's report indicated that the Company was actively preparing a rate increase application for the Northwestern Telephone Systems property located in western Montana. A rate increase became necessary because of several years of significant service improvement projects without corresponding increases in revenues. An application requesting \$1,188,000 was filed on June 29, 1977. The 1977 Mon-

tana legislature passed a law which requires Public Service Commission action within nine months of filing. Public hearings on the application were completed on February 3, 1978 and an order is expected by March 29, 1978.

The Company experienced a 16.5 percent increase in toll messages during 1977, up from an increase of 12.7 percent in 1976 and 10.7 percent in 1975. This rate of increase in toll call-

ing continues to exceed our station growth rate even though our station growth continued at exceptional levels.

The Company's internal growth along with acquisitions, increases in toll volumes and improved rates of return for providing toll service all contributed to a very fine revenue year as reflected in the accompanying financials.

Employees and Labor Relations

The Company had 659 full-time employees at December 31, 1977 compared with 618 at the prior year end. Even with this significant increase, our productivity, as measured by the number of stations served per employee, increased from 224 in 1976 to 235 at year end 1977.

Approximately 60 percent of our employees are covered by five different bargaining units, four of which are represented by either the International Brotherhood of Electrical Workers or the Communication Workers of America, both AFL-CIO affiliates. During the year 1977 all of these contracts came up for renegotiation. Four of the five contracts were settled by exten-

sions of the agreements for three additional years. The wage and benefit packages are generally equivalent to the larger companies in the industry and provide for further wage adjustments based on cost of living and other factors during the balance of the term of the agreements. An offer similar to these settlements is outstanding for the fifth represented group which covers approximately 50 employees. We expect this contract to be resolved early in the current year.

Virtually all of our employee benefit programs have been updated during the last twelve months and are comparable with the industry. Our wage and salary levels likewise compare

closely enabling us to attract and retain competent telephone people.

During the year 1977, Robert E. Unruh, a Vice President for many years, retired and Charles E. Peterson, who had served as Manager of Engineering and Operations, was elected a Vice President with continued responsibilities in those same areas. Since year end, Charles Adams, Controller, has left the Company to assume similar responsibilities with an affiliated organization.

The work force budget for 1978 reflects a further increase in the labor force due to an expected continuation of the high internal growth rate of our business.

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

Years ended December 31, 1977 and 1976

1977

1976

Operating revenues:

Local service	\$11,103,060	\$ 9,749,997
Toll service	23,405,313	20,025,997
Government communication service	1,261,320	1,249,777
Miscellaneous	1,385,670	1,222,094
Total operating revenues	37,155,363	32,247,865

Operating expenses:

Maintenance	6,585,106	5,839,561
Depreciation (Note 1)	6,464,120	5,785,425
Traffic	801,808	818,667
Commercial, administrative and other	5,906,811	5,024,198
Taxes, other than federal income taxes	3,220,240	2,635,029
Federal income taxes (Notes 1 and 6)	3,280,749	2,522,000
Deferred federal income taxes (Notes 1 and 6)	1,241,000	1,108,000
Net deferred investment tax credit (Notes 1 and 6)	1,001,900	967,000
Total operating expenses	28,501,734	24,699,880

Operating income	8,653,629	7,547,985
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Other income:

Allowance for funds used during construction (Note 1)	226,903	273,058
Other, including interest income	63,694	236,943
	290,597	510,001

Interest expense—principally on long-term debt (Note 5)	2,742,470	2,932,483
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Minority interest in net income and preferred stock

dividends of subsidiaries	51,328	63,896
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Income from telephone operations	6,150,428	5,061,607
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Parent operations—interest and expenses—net (Note 5)	344,853	270,661
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Net income	5,805,575	4,790,946
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Preferred stock dividends	30,473	30,473
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Net income applicable to common stock	\$ 5,775,102	\$ 4,760,473
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Net income per common share (Note 1)	\$1.22	\$1.01
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See accompanying notes.

Telephone Utilities, Inc.
CONSOLIDATED BALANCE SHEETS

December 31, 1977 and 1976

1977

1976

Assets

Telephone plant:

Telephone plant in service (Notes 1 and 3)	\$121,067,841	\$110,709,902
Less accumulated depreciation	26,076,880	23,192,791
	94,990,961	87,517,111
Construction work in progress	2,212,301	2,741,583
Net telephone plant	97,203,262	90,258,694

 Cost of acquisitions in excess of equity in
net assets of subsidiaries (Note 1)

10,856,173 10,522,753

Current assets:

Cash	371,626	379,328
Temporary cash investments (Notes 2 and 7)	3,476,114	5,623,259
Accounts receivable	4,457,478	3,791,565
Material and supplies (Note 1)	2,092,977	1,576,414
Prepayments	257,670	201,885
Total current assets	10,655,865	11,572,451

Unamortized debt expense and other deferred charges

351,805 417,651

\$119,067,105 \$112,771,549

See accompanying notes.

1977

1976

Capitalization and Liabilities

Shareholders' equity:

Common stock, authorized 12,000,000 shares of \$1 par value, 4,728,079 shares issued	\$ 4,728,079	\$ 4,728,079
Preferred stock, 6% cumulative, authorized 152,000 shares of \$25 par value, 23,628 shares issued	590,700	590,700
Capital in excess of par value	26,782,317	26,782,317
Retained earnings (Note 3)	21,136,745	16,543,662
	53,237,841	48,644,758

 Less treasury stock, at cost (2,250 shares
of common stock in 1977 and 3,313 shares
of preferred stock in 1977 and 1976)

104,200 82,825

Total shareholders' equity

53,133,641 48,561,933

Minority interest in subsidiaries

368,479 555,809

Long-term debt (Note 3)

43,440,583 45,206,107

Current liabilities:

Accounts payable	6,456,165	5,843,934
Income taxes payable	939,094	707,648
Dividends payable		378,246
Accrued liabilities	1,917,331	1,440,151
Advance billings	997,026	867,311
Current maturities on long-term debt (Note 3)	1,734,149	1,484,288

Total current liabilities

12,043,765 10,721,578

Deferred income taxes (Note 1)

6,066,372 4,800,372

Deferred investment tax credit (Note 1)

3,837,012 2,800,551

Other deferred credits

177,253 125,199

\$119,067,105 \$112,771,549

See accompanying notes.

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

Years ended December 31, 1977 and 1976

1977**1976**

Source of working capital:

From operations:

Net income	\$ 5,805,575	\$ 4,790,946
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Items not involving working capital:

Depreciation and amortization	6,874,519	6,041,482
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Minority interest	31,106	39,835
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Allowance for funds used during construction	(226,903)	(273,058)
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Deferred income taxes and investment tax credit	2,271,900	2,073,000
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Total from operations	14,756,197	12,672,205
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Long-term debt issued and assumed in connection with purchase of subsidiaries	440,750	1,807,312
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Salvage from plant and equipment retired	970,821	805,184
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Decrease in working capital	2,238,773	1,789,707
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	<u>\$18,406,541</u>	<u>\$17,074,408</u>
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Application of working capital:

Property, plant and equipment:

Additions to telephone plant in service	\$14,002,975	\$12,615,526
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Change in construction work in progress—net	(529,282)	(182,137)
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	13,473,693	12,433,389
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Allowance for funds used during construction	(226,903)	(273,058)
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	13,246,790	12,160,331
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Acquired in connection with purchase of subsidiaries—net	938,151	898,637
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	14,184,941	13,058,968
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Addition to cost of acquisitions in excess in net assets of subsidiaries	375,880	798,476
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Reduction of long-term debt	2,206,274	1,475,071
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Cost of removal of plant and equipment	307,106	268,479
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Dividends	1,212,492	1,400,518
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Other—net	119,848	72,896
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	<u>\$18,406,541</u>	<u>\$17,074,408</u>
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Decreases (increases) in the elements of working capital:

Cash and temporary cash investments	\$ 2,154,847	\$ (1,454,128)
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Accounts receivable	(665,913)	297,653
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Material and supplies	(516,563)	(64,337)
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Other current assets	(55,785)	29,773
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Accounts payable	612,231	2,914,391
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Income taxes payable	231,446	491,859
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Current maturities on long-term debt	249,861	(66,644)
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Other current liabilities	228,649	(358,860)
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	<u>\$ 2,238,773</u>	<u>\$ 1,789,707</u>
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See accompanying notes.

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

Years ended December 31, 1977 and 1976

1977

1976

Balance at beginning of year	\$16,543,662	\$13,153,234
Net income	5,805,575	4,790,946
	22,349,237	17,944,180
Deduct:		
Cash dividends:		
Common stock (1977—\$.25; 1976—\$.29 per share)	1,182,019	1,370,045
Preferred stock	30,473	30,473
	1,212,492	1,400,518
Balance at end of year (Note 3)	\$21,136,745	\$16,543,662

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. (TU) and its subsidiaries (Company), all majority-owned. All appropriate intercompany transactions have been eliminated.

In June 1977, TU purchased approximately 94% of the outstanding stock of Creswell Telephone Company for \$793,000. In November 1976, TU purchased all of the outstanding stock of Eastern Oregon Telephone Company for \$1,478,000. Operating results for those companies from the dates of purchase are included in the accompanying consolidated statements of income. Consolidated results of operations for the two years ended December 31, 1977 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 6.0% in 1977 and 5.9% in 1976.

(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 \$1,681,948 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 \$504,500 in 1977 and \$366,310 in 1976, 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, 1977, the unfunded past service costs were approximately \$696,000.

(g) Income taxes

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 \$1,285,300 and \$1,163,000 earned in 1977 and 1976 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 common share

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

2. Transactions with related parties

At December 31, 1977 and 1976, approximately 80% of TU'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 \$196,613 in 1977 and \$232,234 in 1976.

(b) Temporary cash investments

At December 31, 1977 and 1976, temporary cash investments included \$3,300,000 and \$5,400,000, respectively, of short-term advances to Pacific. These advances were made under an agreement providing for the temporary investment by TU of excess cash at the prime commercial rate of interest (Note 5).

(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, 1977 and 1976 consisted of the following:

	1977	1976
2%-8% First Mortgage notes payable to Rural Electrification Administration and Rural Telephone Bank, maturities 1990-2009	\$ 1,895,987	\$ 1,991,278
5%-10¼% First Mortgage notes and bonds, maturities through 1998	18,307,831	19,027,135
7¾% Second Mortgage note, due 1980	11,000,000	11,000,000
5¾%-9¾% Unsecured notes, maturities 1978-2007	13,970,914	14,671,982
	45,174,732	46,690,395
Less current maturities	1,734,149	1,484,288
	<u>\$43,440,583</u>	<u>\$45,206,107</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 TU's stock. Retained earnings of \$9,838,000 are not restricted at December 31, 1977.

Total long-term debt maturing annually within each of the four years after December 31, 1978 is as follows:

1979	\$ 1,828,916	1981	\$ 1,643,942
1980	\$ 12,664,644	1982	\$ 1,219,793

4. Stock Option Plan

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, 1977, no options had been granted under the plan.

5. Parent operations

Parent operations of TU are summarized as follows:

	1977	1976
Interest income:		
From subsidiaries	\$ 6,505	\$ 156,224
From temporary cash investments (Note 2)	357,499	409,583
	<u>364,004</u>	<u>565,807</u>
Interest expense:		
To subsidiaries	42,186	311,374
Other—principally on long-term debt	876,730	729,918
	<u>918,916</u>	<u>1,041,292</u>
Federal income tax (credit):		
Federal income taxes	(325,000)	(247,000)
Deferred federal income taxes	25,000	(3,000)
Net deferred investment tax credit	4,000	1,000
	<u>(296,000)</u>	<u>(249,000)</u>
Other expense—net	85,941	44,176
	<u>\$ 344,853</u>	<u>\$ 270,661</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:

	1977	1976
Excess of tax over book depreciation	\$ 1,153,000	\$ 1,003,000
Cost of removal of retired assets deducted for tax purposes	113,000	102,000
	<u>\$ 1,266,000</u>	<u>\$ 1,105,000</u>

The Company's effective federal income tax rate was 47.2% in 1977 and 1976. The difference between this effective rate and the 48% federal income tax statutory rate is attributable to the following:

	1977	1976
Interest, taxes and pensions capitalized	2.5%	2.8%
Amortization of investment tax credit	2.5	2.1
Other	(4.2)	(4.1)
	<u>.8%</u>	<u>.8%</u>

7. Commitments

Expenditures in connection with the Company's construction program will approximate \$16,500,000 in 1978. Cash now temporarily invested (Note 2) will be utilized in connection with the construction expenditures.

Total rental expenses for 1977 and 1976 are as follows:

	1977	1976
Pole contacts	\$ 299,542	\$ 294,543
Other, including short-term rentals .	133,567	148,564
	<u>\$ 433,109</u>	<u>\$ 443,107</u>

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

8. 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 costs at December 31, 1977 and 1976.

9. Quarterly financial data

Summarized quarterly financial data (unaudited) for 1977 and 1976 is as follows:

	Three Months ended			
	March 31 1977	June 30 1977	Sept. 30 1977	Dec. 31 1977
Operating revenues . .	<u>\$8,680,590</u>	<u>\$8,913,524</u>	<u>\$9,339,574</u>	<u>\$10,221,675</u>
Operating income . . .	<u>\$2,003,914</u>	<u>\$2,042,738</u>	<u>\$2,157,462</u>	<u>\$ 2,449,515</u>
Net income .	<u>\$1,301,695</u>	<u>\$1,318,892</u>	<u>\$1,443,005</u>	<u>\$ 1,741,983</u>
Net income per common share	<u>\$.27</u>	<u>\$.28</u>	<u>\$.30</u>	<u>\$.37</u>

	Three Months ended			
	March 31 1976	June 30 1976	Sept. 30 1976	Dec. 31 1976
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>

Auditors' Opinion

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

We have examined the consolidated balance sheets of Telephone Utilities, Inc. and subsidiaries as of December 31, 1977 and 1976 and the related consolidated statements of income, retained earnings and changes in financial position for the years then ended. Our examinations were 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, 1977 and 1976 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.

Haskins & Sells

Portland, Oregon
February 3, 1978

Common Stock Telephone Utilities, Inc.

Range of Bid and Asked Prices for Quarters Ended

	Bid		Asked	
	High	Low	High	Low
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
March 31, 1977	8½	6	9¼	6¾
June 30, 1977	8¾	7¼	9¾	8
September 30, 1977	10	7¾	11½	8½
December 31, 1977	11¼	8½	12	9½

Cash dividend payable dates: Per Share

February 2, 1976	\$.07
May 3, 1976	\$.07
August 2, 1976	\$.07
November 1, 1976	\$.07
February 7, 1977	\$.08
May 16, 1977	\$.08
August 22, 1977	\$.08
November 28, 1977	\$.09

Stock is traded in National OTC Market

NASDAQ—TPHN

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

C. E. PETERSON
Vice President

BRIAN M. WIRKKALA
Secretary-Treasurer

JAMES E. AYDELOTT
Chief Engineer

MARGARET WANN
Assistant Secretary

MARVA J. WIRKKALA
Assistant Treasurer

Directors

B. LAMAR GAINES
Retired
North Bend, Washington

JOHN H. GEIGER
Vice President of the Company and
Vice President-Finance of
Pacific Power & Light Company
Portland, Oregon

A. M. GLEASON
President of the Company

LEWIS C. NEACE, M.D.
Senior Vice President
of the Company
and Practicing Physician

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

Transfer Agent and Registrar

First National Bank of Oregon
Portland, Oregon

General Counsel

Rives, Bonyhadi & Smith
Portland, Oregon

Special Counsel

Bogle & Gates
Seattle, Washington

Auditors

Haskins & Sells
Portland, Oregon

FORM 10-K

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.

ANNUAL MEETING

The Annual Meeting of Shareholders of Telephone Utilities, Inc. will be held at 10:30 a.m., Mountain Standard Time, on Monday, April 24, 1978 at the Outlaw Inn, Kalispell, Montana 59901.



**Telephone
Utilities, Inc.**