Federal Communications Commission
Washington, D.C. 20554

October 9, 2003

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: Federal-State Joint Conference on Accounting Issues, WC Docket 02-269

Dear Ms. Dortch:

By this letter, the Federal-State Joint Conference on Accounting Issues (Joint Conference) transmits a report detailing a series of proposed recommendations to the Commission's accounting requirements. Pursuant to section 410(b) of the Communications Act of 1934, as amended (the Act), the Commission convened the Federal-State Joint Conference on Accounting Issues "to provide a forum for an ongoing dialogue between the Commission and the states in order to ensure that regulatory accounting data and related information filed by carriers are adequate, truthful, and thorough."[1] The attached report reflects the work of the Joint Conference between October 17, 2002 and October 6, 2003. The Joint Conference respectfully requests the Commission issue a Notice of Proposed Rulemaking seeking comment on the report and consider adopting the Joint Conference's recommendations.

Respectfully submitted,

The Honorable Kevin J. Martin, Commissioner
Federal Communications Commission

The Honorable Michael J. Copps, Commissioner
Federal Communications Commission

The Honorable Nancy Brockway, Commissioner
New Hampshire Public Utilities Commission

The Honorable Terry Deason, Commissioner
Florida Public Service Commission

The Honorable Rebecca A. Klein, Chairman
Texas Public Utilities Commission

The Honorable Loretta Lynch, President
California Public Utilities Commission

The Honorable Diane Munns, Chair
Iowa Utilities Board

[1] *Federal-State Joint Conference on Accounting Issues*, Order, 17 FCC Rcd 17025, para. 1 (2002) (*Convening Order*); *see* 47 U.S.C. § 410(b).

In the Matter of)
)
Federal-State Joint Conference) WC Docket No. 02-269
On Accounting Issues)

RECOMMENDATION BY JOINT CONFERENCE

By the Joint Conference: Commissioners Martin and Copps issuing separate statements. Commissioners Brockway, Deason, Klein, Lynch, and Munns agreeing, without separate statements.

I. EXECUTIVE SUMMARY 2

II. INTRODUCTION 3

III. BACKGROUND 4

A. History Of Phase II 4
B. Biennial Review Standard 6

IV. MODIFICATIONS TO PART 32 8

A. Consolidation Of Directory Revenues (Acct. 5230) Into Miscellaneous Revenue (Acct. 5200) 8
B. Consolidation Into One Services Account (6620) And Creation Of Wholesale/Retail Subaccounts 10
C. Consolidation Of Accounts 6561-6565 Into One Depreciation And Amortization Expense Account (6562) 15
D. Addition Of Accounts 16
1. Optical Switching 18
2. Switching Software 18
3. Loop And Interoffice Transport 19
4. Interconnection Revenue (with subaccounts UNEs, Resale, Reciprocal Compensation, and Other Interconnection Arrangements) 19
5. Universal Service Support 21

V. AFFILIATE TRANSACTIONS REQUIREMENTS 21

A. Elimination Of The Requirement For Fair Market Value Comparison For Asset Transfers Below $500,000 21
B. Establishment Of Floor And Ceiling For Recording Transactions 22
C. Prevailing Price Treatment Threshold 23
D. Modification Of The Centralized Services Exception To The Estimated Fair Market Value Rule 24
E. Exemption Of Nonregulated To Nonregulated Transactions From The Affiliate Transactions Rules 26
F. Intra-Holding Company ILEC To ILEC Transfers Of Assets Or Services 27
G. Affiliate Transactions And Section 272 27

VI. REPORTING REQUIREMENTS AND OTHER ISSUES 31

A. Collection Of Local Loop Facilities Data As Loop Sheath Kilometers 31
B. Broadband Infrastructure Reporting 32
C. Dominant Vs. Non-Dominant Carriers 34

I. EXECUTIVE SUMMARY

The Joint Conference requests that the Commission issue a formal Notice of Proposed Rulemaking (NPRM) seeking comment on the following recommendations:

- Modifications to Part 32:

  1. The FCC should reinstate Account 5230, Directory Revenue, so that this line of business revenue can be monitored separately.

  2. The FCC should reinstate Account 6621, Call Completion Services, Account 6622, Number Services, and Account 6623, Customer Services.

  3. The FCC should reinstate the separate depreciation and amortization Accounts 6561-6565.

  4. The FCC should revise its Part 32 rules to add the following separate accounts:

     Optical Switching
     Switching Software
     Loop and Interoffice Transport
     Interconnection - Revenue (with subaccounts for UNE's, Resale, Reciprocal Compensation and Interconnection Arrangements)
     Universal Service Support Revenue
     Universal Service Support Expense

- Affiliate Transactions Requirements:

  1. The FCC should affirm the requirement for a comparison between net book cost and fair market value for the first $500,000 of asset transfers.

  2. The FCC should reverse its decision to permit ILEC discretion in valuing affiliate transactions.

  3. The FCC should reinstate the threshold required to qualify for prevailing price valuation of affiliate transactions to 50 percent of sales of a particular asset or service to third parties.

  4. The FCC should eliminate the centralized services exemption.

  5. The FCC should maintain the current reporting requirements for nonregulated to nonregulated affiliate transactions and take no additional action at this time.

6. The FCC should apply its affiliate transactions rules to transactions between ILECs within the same holding company.

7. The FCC should require BOCs, following the elimination of the affiliate and nondiscriminatory requirements of section 272, to maintain separate books of account for the provision of interexchange service and maintain an affiliate that provides in-region interexchange service that is subject not only to accounting review but also to certain safeguards.

► Reporting requirements and other issues:

1. If the requirement to collect local loop facilities as loop sheath kilometers on ARMIS Report 43-07 is retained, the FCC should also reinstate the reporting of sheath kilometer reporting requirement for some period.

2. The FCC should deny reconsideration petitions regarding the reporting of broadband infrastructure data in ARMIS Report 43-07, while continuing to evaluate whether the data collection should be expanded to a larger universe of carriers.

3. The FCC should affirm that the amendment adopted to rule 32.11 of its accounting and reporting rules apply to all incumbent local exchange carriers as generally defined in section 251(h).

II. INTRODUCTION

On September 5, 2002, the Federal Communications Commission (FCC or Commission) issued a *Convening Order* establishing a Federal-State Joint Conference on Accounting Issues (Joint Conference), to "provide a forum for an ongoing dialogue between the Commission and the states in order to ensure that regulatory accounting data and related information filed by carriers are adequate, truthful, and thorough."[1] According to the *Convening Order*, the Joint Conference, "will further this goal by facilitating cooperative federal and state review of regulatory accounting and related reporting requirements in order to determine their adequacy and effectiveness in the current market and make recommendations for improvement."[2]

Subsequently, the Commission issued an *Order* that suspended implementation of four accounting and record keeping rule modifications adopted by the *Phase II Report and Order*: (1) the consolidation of Accounts 6621 through 6623 into Account 6620, with subaccounts for wholesale and retail; (2) the consolidation of Account 5230, Directory Revenue, into Account 5200, Miscellaneous Revenue; (3) the consolidation of the depreciation and amortization

---

1 *Federal-State Joint Conference on Accounting Issues,* Order, WC Docket No. 02-269, FCC 02-240, para. 1 (rel. September 5, 2002) (*Convening Order*).

2 *Convening Order* at para. 1.

expense accounts (Accounts 6561 through 6565) into Account 6562, Depreciation and Amortization Expenses; and (4) the revised "Loop Sheath Kilometers" data collection in Table 11 of ARMIS Report 43-07.[3] The Commission concluded that further consideration of these changes before their implementation would advance the work of the Joint Conference.

On December 12, 2002, the Joint Conference issued a *Joint Conference Public Notice* with respect to its comprehensive review of regulatory accounting and related reporting requirements.[4] The *Joint Conference Public Notice* requested comment on a number of the issues that were addressed in the *Phase II Report and Order.* Specifically, comment was requested with respect to (1) the accounts requested by states but not added in Phase II; (2) the provisions of the *Phase II Report and Order* that were suspended by the Commission in its November 12, 2002 *Order*; (3) the provisions of issues raised by the outstanding petitions for reconsideration of the *Phase II Report and Order*; and (4) the *Phase II Report and Order* changes to affiliate transaction rules.

III. BACKGROUND

A. History Of Phase II

In 1999, the Commission initiated a two-phased comprehensive review of its accounting rules and the related reporting requirements for incumbent local exchange carriers (ILECs) to keep pace with changing conditions in a competitive telecommunications industry. In Phase 1, which concluded with the *Phase I Report and Order*, the Commission adopted accounting rule changes and reporting reform measures for the Automated Reporting Management Information System (ARMIS) that could be implemented quickly.[5] In 2000, the Commission released a *Phase II Notice* wherein it commenced a Phase II comprehensive, biennial review to further revise its rules and reporting requirements in the near term by streamlining the chart of accounts, revising the affiliate transactions rules, modifying other accounting rules, and streamlining the ARMIS reporting requirements.[6] Concurrent with the *Phase II Notice*, the Commission

---

[3] *Federal-State Joint Conference on Accounting Issues; 2000 Biennial Regulatory Review–Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*; WC Docket No. 02-269 and CC Docket Nos. 00-199, 80-286, and 99-301, Order, FCC 02-309 (rel. November 12, 2002), FCC 03-141 (rel. June 24, 2003). The November 12, 2002, Order suspended implementation to July 1, 2002; the June 24, 2003, Order extended the suspension until January 1, 2004.

[4] *Federal-State Joint Conference on Accounting Issues*, Request for Comment, WC Docket 02-269, DA 02-3449. (Issued December 12, 2002) (*Joint Conference Public Notice*).

[5] *Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 1*, CC Docket No. 99-253, Report and Order. (*Phase I Report and Order*).

[6] *2000 Biennial Regulatory Review–Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2 and Phase 3*, CC Docket No. 00-199, Notice of Proposed Rulemaking, FCC 00-364 (rel. October 18, 2000) at para. 1 (*Phase II Notice*).

undertook a Phase 3 review focusing on a broader examination of Part 32[7] and ARMIS reporting requirements for more significant deregulation.[8]

Subsequent to the release of the *Phase II Notice*, the Commission adopted the recommendation of the Federal-State Joint Board on Separations to impose an interim freeze of Part 36[9] cost allocation rules for price cap carriers and rate-of-return carriers.[10] Additionally, on June 8, 2001, the Commission released a further notice seeking further comment on proposed additions, consolidations, or eliminations of certain Class A and Class B accounts.[11]

The Phase II review concluded with the *Phase II Report and Order* in which the Commission adopted further streamlining measures to its accounting rules and reporting requirements.[12] These revisions were based on determinations that specific accounting rules and reports were no longer necessary or were outdated in the "pro-competitive, deregulatory" national policy framework for the telecommunications industry.[13] Specifically, the revisions were intended to "reflect a sharpened focus on ongoing regulatory needs in the areas of competition and universal service,"[14] and minimize the regulatory burdens and distortions that could undermine the development of new technology. Concurrently, in a related *Further Notice of Proposed Rulemaking*, the Commission sought to refresh the Phase 3 record by requesting comment on certain accounting and related reporting requirements identified for future reform.

The *Phase II Report and Order* eliminated many Part 32[15] accounts and reduced ARMIS reporting requirements for mid-sized local exchange carriers.[16] On its own motion, the

---

7 47 C.F.R. Part 32.

8 *Phase II Notice* at para. 2.

9 47 C.F.R. Part 36.

10 *Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Report and Order, FCC 01-162 (rel. May 22, 2001) (*Separations Freeze Order*).

11 *2000 Biennial Regulatory Review–Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2 and Phase 3*, CC Docket No. 00-199, Commission Seeks Further comment in Phase 2 of the Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers, DA 01-1403 (rel. June 8, 2001) (*Phase II Further Notice*). After reviewing the comments, the FCC sought further comment on streamlining Class A and Class B accounts.

12 *2000 Biennial Regulatory Review–Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2; Amendments to the Uniform System of Accounts for Interconnection; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*, CC Docket Nos. 00-199, 97-212, 80-286, and 99-301, Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286 (*Phase II Report and Order*), Further Notice of Proposed Rulemaking in CC Docket Nos. 00-199, 99-301, and 80-286, FCC 01-305 (rel. November 5, 2001) (*Further Notice of Proposed Rulemaking*).

13 *Phase II Report and Order* at para. 2.

14 *Id.* at para. 4.

15 47 C.F.R. Part 32.

16 *Phase II Report and Order* at para. 5.

Commission issued limited reconsideration of the rules adopted in the *Phase II Report and Order*.[17]

On March 8, 2002, BellSouth Corporation, SBC Communications Inc., and Verizon filed a joint petition for reconsideration of the *Phase II Report and Order*.[18] The petitioners asked that two newly created subaccounts - the wholesale and retail subaccounts to Account 6620, Services - be eliminated. The petitioners also requested that the Commission change the reporting of "Loop Sheath Kilometers" back to "Sheath Kilometers." The petitioners argued that the Commission should delay implementation of the relevant rule changes pending review of the arguments raised in the reconsideration petition. AT&T Corp. opposed both the petition for reconsideration and the request to delay implementation.[19]

B. Biennial Review Standard

The biennial review of the accounting rules and the ARMIS reporting requirements was driven by section 11 of the Communications Act of 1934. That law, adopted in 1996, requires the FCC to review every two years those regulations that are "no longer necessary in the public interest as the result of meaningful economic competition between providers . . ."[20] On November 5, 2001, the Commission released its *Phase II Report and Order* to meet the biennial review requirements with respect to accounting and ARMIS reporting requirements.[21] The Commission appeared to define the public interest standard in section 11 as synonymous with federal purpose. Analysis of different accounts under the Phase II process was undertaken according to the "federal purpose" standard. In the Further Notice of Proposed Rulemaking, paragraph 207, the FCC stated "[w]e believe that, if we cannot identify a federal need for a regulation, we are not justified in maintaining such a requirement at the federal level."

---

[17] *2000 Biennial Regulatory Review–Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers*, CC Docket No. 00-199, Order on Reconsideration, FCC 02-68 (rel. March 8, 2002) (*Order on Reconsideration*). The Commission reinstated Account 3400, Accumulated Amortization - Tangible, a Class B account, at the request of United States Telecom Association. At Sprint's request, the Commission clarified that mid-sized carriers are not required to file ARMIS 43-02 (USOA Report), 43-03 (Joint Cost Report), and 43-04 (*Separations and Access Report*). Finally, at the request of the Bell Operating Companies, the Commission extended the effective date of the changes to the Part 32 chart of accounts, and derivative changes to Parts 51 and 54 to January 1, 2003.

[18] Petition of BellSouth, SBC and Verizon for Reconsideration of Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286 (filed March 8, 2002) (*Joint Petition for Reconsideration*). The Joint Petition also asked the Commission to reconsider its decision to collect certain new data concerning deployment of broadband facilities in ARMIS pending further consideration of broadband reporting requirements in Phase 3 of the proceeding. *Joint Petition for Reconsideration* at 1-11. In addition, SBC filed a separate petition for reconsideration seeking changes to the amended rule 32.11, 47 C.F.R. § 32.1, which is the rule that specifies which carriers are subject to regulated accounting requirements. SBC Communications, Inc. Petition for Reconsideration (filed March 8, 2002) (*SBC Reconsideration).*

[19] Opposition of AT&T Corporation to Petitions for Reconsideration, (filed May 15, 2002) (*AT&T Opposition*).

[20] 47 U.S.C. § 161.

[21] See, *Phase II Report and Order*.

In *Louisiana PSC*, the Supreme Court discussed the Commission's ability to impose accounting requirements pursuant to section 220 of the Communications Act.[22] Even though the case was decided prior to the Congress enacting the local competition provisions in 1996, the case nonetheless recognized that the realities of technology and economics make a clean parceling of responsibility between the state and federal jurisdictions difficult. The Court reasoned that virtually all telephone plant that is used to provide intrastate service is also used to provide interstate service. The Court stated, "[m]oreover, because the same carriers provide both interstate and intrastate service, actions taken by federal and state regulators within their respective domains necessarily affect the general financial health of those carriers, and hence their ability to provide service, in the other 'hemisphere.'"[23] The division of domestic telephone service neatly into two hemispheres, one comprised of interstate and the other made up of intrastate service, was further complicated by the 1996 Act.

The Supreme Court declined to specifically define the scope of the accounting jurisdiction under section 220. It stated it is possible that the section was to do no more than spell out the authority of the FCC over depreciation in the context of interstate regulation. But it also stated that it is similarly plausible that the section was addressed to the plenary authority of the FCC to dictate how the carriers' books would be kept for the purposes of financial reporting in order to ensure that investors and regulators would be presented with an accurate picture of the financial health of the carriers.[24]

These two possible purposes of section 220 become relevant in reviewing the FCC's application of the definition of "public interest" to its accounting requirements in its biennial review. The Commission appears to have applied the more limited purpose of section 220 discussed by the Court, that being whether the FCC uses the information in exercising specifically defined duties related to interstate service.

After the FCC finished its review and issued its order in 2001, the financial and accounting scandals that rocked the telecommunications industry began to surface. The economic impact on individual carriers as well as on the country as a whole has not been fully quantified but is known to be significant. The FCC "convened this Joint Conference on Accounting Issues to provide a forum for an ongoing dialogue between the Commission and the states in order to ensure that regulatory accounting data and related information filed by carriers are adequate, truthful and thorough."[25] The Joint Conference was charged to facilitate "cooperative federal and state review of regulatory accounting and related reporting requirements in order to determine their adequacy and effectiveness in the current market and make recommendations for improvements."[26] The Commission stated:

[22] *Louisiana PSC v. FCC*, 476 U.S. 355 (1986) (*Louisiana PSC*).

[23] *Id*. at 360.

[24] *Id*. at 377-78.

[25] *See Covening Order* at para. 1.

[26] *Id*.

> The Joint Conference will have a broad mandate to evaluate accounting requirements that state and federal regulators need to carry out their responsibilities. This analysis could include, among other things, an evaluation of current regulatory accounting rules, consideration of the scope of these rules, and an examination of any additions or eliminations of accounting requirements. The Conference may utilize existing federal and state data collection procedures and conduct hearings to collect information necessary to further the development of improved regulatory accounting and related reporting requirements and ensure that data filed by carriers are adequate, truthful, and thorough.

The effective date of several Phase 2 changes was also put on hold so the Joint Conference could reexamine the changes and make recommendations. These charges and responsibilities entrusted to the Joint Conference follow the broader purpose of section 220,[27] to ensure that investors and regulators are presented with an accurate picture of the financial health of the carriers.

While under the *Louisiana PSC* case the states are free to prescribe their own accounting requirements and are not preempted by the FCC, it is apparent that viewing data on a limited state-by-state basis without the context of national data makes it very difficult to accurately measure the "financial health of the carriers." It is also more burdensome to require fifty or more potentially different accounting requirements as opposed to collecting data at a national level. Thus, as a result of its work under the broad mandate of the *Convening Order*, the Joint Conference believes that the Commission may adopt accounting requirements to meet the needs of the states and other stakeholders.

IV. MODIFICATIONS TO PART 32

A. Consolidation Of Directory Revenues (Acct. 5230) Into Miscellaneous Revenue (Acct. 5200)

Issue: Should the FCC reverse its decision to consolidate Account 5230, Directory Revenue, into Account 5200, Miscellaneous Revenue?

Recommendation: Yes. The FCC should reinstate Account 5230, Directory Revenue, so that this line of business revenue can be monitored separately.

The Telecommunications Act of 1996 established specific rules and regulations that allowed Regional Bell Operating Companies (RBOCs, also known as Bell Operating Companies (BOCs)) to enter lines of businesses that they had been prohibited from participating in at divestiture. Revenues derived from these affiliated lines of businesses are required to be tracked separately, whether an RBOC is operating under traditional rate of return, or using some form of alternative regulation. Before issuance of the Modified Final Judgment (MFJ)[28] in 1984, the

---

[27] 47 U.S.C. § 220.

[28] *United States v. Western Electric Co.*, 569 F. Supp. 990 (1983).

local Bell telephone companies published and distributed alphabetical and classified telephone directories (the white and yellow pages) within their service territories. The cost and revenues associated with those publications were considered part of the telephone company's operations. In other words, publication of telephone directories was part of the local telephone company's service obligations, and the revenues from directory publishing and advertising were used to defray the utility's revenue requirement.

Subsequent to divestiture, those directory operations were transferred to a non-regulated affiliate, with revenues for services rendered under these agreements booked to Account 5230, consistent with FCC (Part 32[29]) accounting rules, the Uniform System of Accounts for Telecommunications Companies (USOA). The intent was that ratepayers would continue to receive the economic benefit from the licensing, publishing, distribution and revenue sharing agreements. The revenues derived from the directory operations have flowed back to the BOC and have been reported in Account 5230, Directory Revenues. These revenues have been treated "above-the-line"[30] for intrastate revenue requirement determinations. Many of the states, in moving to alternative forms of regulation, have put in place an imputation of the Directory Revenues, which necessitates distinct and detailed accounts.

The *Phase II Report and Order* consolidated Account 5230, Directory Revenues, into Account 5200, Miscellaneous Revenue. Directory Revenues are created through a separate and distinct line of business and as such should be accounted for separately. The purpose of a "miscellaneous" account is to alleviate the need for hundreds of individual revenue accounts to account for small, insignificant amounts. Clearly, the amounts recorded for directory revenues are not insignificant. Directory revenues would often be one of the largest components recorded as miscellaneous revenue.[31]

The elimination of the Directory Revenues Account will result in the commingling of a variety of revenues into one reported amount. This would likely include revenues from retail, corporate operations, customer operations, and other incidental regulated revenue. For states still operating under rate of return regulation, as well as those using alternative forms of regulation, directory revenue is a source of controversy. The information provided by a separate accounting of directory revenues is necessary to the state regulators as they carry out the responsibility under the 1996 Act to protect consumers and competition against the incumbents' use of its local monopolies to gain a competitive advantage in the market for directory listings.[32]

---

[29] 47 C.F.R. Part 32.

[30] "Above-the-line" refers to those services that the Commission includes to calculate a carrier's revenue requirement when setting rates.

[31] Comments of the Public Service Commission of Wisconsin to the Joint Conference Request for Comment, WC Docket No. 02-269 (*Wisconsin Comments*) at 5. Comments of the National Association of State Utility Consumer Advocates to the Joint Conference Request for Comment (*NAUSCA Comments*), WC Docket No. 02-269, at 14.

[32] Comments of AT&T Corp. to the Joint Conference Request for Comment, WC Docket No. 02-269, (*AT&T Comments*) at 14. *See* also, *NASUCA Comments* at 14.

B. Consolidation Into One Services Account (6620) And Creation Of Wholesale/Retail Subaccounts

Issue: Should the Commission reverse its Phase II decision to consolidate Account 6621, Call Completion Services, Account 6622, Number Services, and Account 6623, Customer Services, into Account 6620, Services and create wholesale and retail subaccounts to the newly consolidated account?

Recommendation: Yes. The Commission should reverse its Phase II decision. In addition, the FCC should seek comment on other measures that could be used to achieve the *Phase II Report and Order* goals of 1) recognizing an increased importance of the wholesale versus retail distinction as competition develops in the local exchange market and 2) assisting the states in developing unbundled network element (UNE) rates that properly reflect the costs of providing a wholesale service. Finally, the FCC should direct the ILECs to quantify the burdens associated with each alternative.

The Commission should seek comment on consolidating Accounts 6621, Call Completion Services (operator services), and 6622, Number Services (directory assistance), into one account and retaining Account 6623, Customer Services, as a separate account. Regarding the creation of separate wholesale and retail subaccounts, the Commission should request comment on whether modifying ARMIS Report 43-02 to require the reporting of the wholesale/retail percent of customer services expense (Account 6623) would provide sufficient information in determining costs of providing wholesale services rather than creating the new subaccounts in the Part 32[33] accounting rules. Because ARMIS Report 43-02 is reported on an operating company basis, ILECs should be required to report the wholesale/retail percent on an individual state basis. The wholesale/retail percentage would be determined annually on a study basis that ILECs already use in UNE proceedings. This will provide information that can be used to set UNE rates and develop the discount for resale rates, without the burdensome requirement of maintaining separate subaccounts and the need to separately journalize retail and wholesale components.

If wholesale/retail subaccounts are created, the Commission should also seek comment on the propriety of making the new subaccounts applicable only to Account 6623, Customer Services, inasmuch as operator services and directory assistance are not required to be offered at UNE rates. The FCC should seek comment on how to define and distinguish wholesale and retail customer services costs.

The *Phase II Report and Order* concluded that Accounts 6621-6623 (Account 6621, Call Completion Services, Account 6622, Number Services, and Account 6623, Customer Services) should be consolidated into Account 6620, Services.[34] Further, the *Phase II Report and Order*

---

[33] 47 C.F.R. Part 32.

[34] *Phase II Notice*, Appendix 3, p. 46; Appendix 5, p. 49. The *Phase II Notice* proposed the consolidation of the services accounts (accounts 6620-6623) into one account 6620. The *Phase II Notice* also sought comment on creating subaccounts for customer operations expense to separately record expenses associated with wholesale and

created wholesale and retail subaccounts for the consolidated account.[35] The FCC noted that the "wholesale versus retail distinction is important," that this distinction likely would "increase in importance as competition develops in the local exchange market," and that "[a]dding these new subaccounts w[ould] assist the states in developing UNE rates that properly reflect the costs of providing a wholesale service." The FCC acknowledged that the wholesale versus retail distinction is important for customer service. This is because the per-line expenditure for customer service is higher at the retail level since competitive local exchange carriers (CLECs) (wholesale customers) do most of the customer service functions themselves. While ILECs opposed the addition of the wholesale and retail subaccounts and argued that the burden of adding the subaccounts outweighed any potential benefits, the *Phase II Report and Order* noted that the alleged burden had not been quantified.[36]

In the *Joint Petition for Reconsideration*, the ILECs seek elimination of the newly created wholesale and retail services subaccounts because they are unnecessary, conflict with existing regulations, and are extremely burdensome to implement.[37] The *Joint Petition for Reconsideration* requests a delay in implementing the new subaccounts until six months after publication in the Federal Register of the final ruling on the reconsideration petition.[38] Finally, the *Joint Petition for Reconsideration* seeks delay in implementing these subaccounts until after the FCC has concluded Phase 3 where various proposals could reshuffle Class A accounting and affect the creation of wholesale and retail subaccounts.[39]

The ILECs admit in the *Joint Petition for Reconsideration* that the distinction between wholesale and retail services is important in the marketplace, but argue that it is unnecessary and burdensome to carry that separation into expense accounting. Additionally, the ILECs assert that the accounting costs included in the wholesale and retail subaccounts would not be comparable to the forward-looking costs included in UNE cost studies. The *Joint Petition for Reconsideration* argues that operator services and directory assistance are not required to be offered at UNE rates. There is therefore no reason to create wholesale and retail subaccounts for these services that are provided and priced independently from UNEs.[40]

Regarding the burden of creating wholesale and retail subaccounts for the consolidated services account, the *Joint Petition for Reconsideration* asserts that the services encompassed in Account 6620 are provided to both retail and wholesale customers using the same systems and operators. Because the expenses are functionally the same, the ILECs assert that they are not easily broken into subaccounts for wholesale versus retail.[41] In order to comply with the *Phase II*

---

retail services. The subaccounts were specifically proposed by the states to meet changing regulatory needs.

35 *Phase II Report and Order* at para. 64.

36 *Id*.

37 *See Joint Petition for Reconsideration* at 1.

38 *Id*. at 2.

39 *Id*. at 7.

40 *Id*. at 3-4.

41 *Id*.

Report and Order, the ILECs allege that they will have to undertake special studies to create subaccounts for the consolidated services account, either through allocation or by changing internal operating systems and procedures to allow for direct assignment. Either way, they argue, will be burdensome and time consuming.

Under the allocation method, Verizon estimates that it would take at least four to six months to structure and conduct special studies to create wholesale and retail subaccounts for the consolidated services account, costing close to $3.5 million in additional implementation costs, and over $2.5 million per year in ongoing costs.[42] These studies would be necessary to determine 1) the portion of the services expenses associated with the wholesale function and which are associated with the retail functions, 2) the portion of billing and collection costs are attributable to each, and 3) the portion of the employees' time that are related wholesale versus retail. However, in comments filed to the *Joint Conference Public Notice*, USTA, SBC, and Verizon note that FCC Rule Section 32.2(c) states that the regulated accounting system is based on actual costs, not allocated costs like that in Part 36[43] (Jurisdictional Separations Procedures) and Part 64[44], Subpart I (Allocation of Costs).[45] In this respect, using a cost allocation approach to create wholesale and retail subaccounts would not be consistent with the FCC's accounting rules. SBC asserts that undertaking studies to allocate costs is unduly burdensome and costly. Furthermore, SBC argues that factors developed from studies performed during a prior period would be applied to current data, and therefore, would only reflect a representation of costs associated with wholesale and retail activities related to customer services rather than the actual costs incurred for such purposes.[46]

If operational system changes are made to segregate the expenses into wholesale and retail for the consolidated services account, BellSouth has estimated an 18-month implementation period at a cost of about $12.5 million.[47] Existing billing systems would have to be separated and duplicated. In *ex parte* discussions, BellSouth explained that underlying accounting codes and methodology are already established to capture wholesale and retail expenses for customer services, Account 6623. However, operator services and directory assistance systems do not currently distinguish between wholesale and retail; there are currently no procedures or identifiers in place like there are with Account 6623. This will mean extensive and burdensome modifications to existing internal operations to create the methodology and tracking of separate wholesale and retail expenses.

---

[42] *Id*. at 5-6.

[43] 47 C.F.R. Part 32.

[44] 47 C.F.R. Part 64.

[45] Comments of the United States Telecom Association, January 31, 2003, (*USTA Comments*) at 5-6; Comments of SBC Communications Inc., January 31, 2003, (*SBC Comments*) at 17; Comments of Verizon to Joint Conference Request for Public Comment, January 31, 2003, (*Verizon Comments*) at 18-20.

[46] *SBC Comments* at 16-17.

[47] *Joint Petition for Reconsideration* at 6.

In opposition to the *Joint Petition for Reconsideration*, AT&T argues that the petition provides no basis for reconsidering the conclusions of the *Phase II Report and Order*.[48] AT&T alleges that the *Joint Petition for Reconsideration* ignores the record supporting the new subaccounts as well as the FCC's conclusion that these new subaccounts will increase in importance as competition develops. Additionally, AT&T asserts that these subaccounts are important in assessing ILEC compliance with its duty "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers."[49] AT&T alleges that total element long-run incremental cost (TELRIC) pricing of UNEs looks to "forward-looking economic cost-based pricing," but UNE pricing also reflects common costs, loading factors and other overhead costs attributable to the costs of operating a wholesale network. Routinely, those costs are assessed by reviewing ARMIS accounts based on the theory that historical ratios of such costs to investment may serve as a proxy (or at least a starting point) for estimating forward-looking levels of these costs. For this reason, the FCC's decision to create separate accounts for wholesale and retail services will assist the states in the development of UNE rates that properly reflect the costs of providing wholesale service.[50] Moreover, AT&T asserts that the *Joint Petition for Reconsideration* makes no additional effort to describe or quantify the burden this accounting requirement would impose.[51]

In reply to the *AT&T Opposition*, the ILECs argue that, while such costs may be used as a "starting point" for UNE rates or in determining resale rates, carriers must perform studies to determine these costs and set forth details of how the analyses were performed. The ILECs argue that the *Phase II Report and Order* will require studies to be undertaken on a more frequent basis and require carriers to journalize these costs on a monthly basis. Requiring monthly, journalized entries is inefficient for UNE and resale purposes because these proceedings generally do not take place every year. Moreover, no analysis has been performed to determine whether less burdensome measures could be used to achieve the stated goals.[52]

In its comments to the *Joint Conference Public Notice*, BellSouth suggests that if states need a wholesale component, the wholesale percentage determined on a study basis could be reported in ARMIS. This would serve the states alleged need for the information without causing ILECs to incur undue burdens of splitting these expenses between wholesale and retail for journalization on a monthly basis.[53] Having this data reported in ARMIS should reduce the amount of discovery in UNE filings. ILEC costs should be minimal since the procedures are already in place for these special studies and will not require the changing of internal operating

---

48 *AT&T Opposition* at 6.

49 47 U.S.C. § 251(c)(4)(A).

50 *Id*. at 7. See also, *Phase II Report and Order* at para. 64; Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, 11 FCC Rcd. 15499, para. 691 (1996) (*Local Competition Order*) (explaining that "directly attributable costs" are relevant to pricing of UNEs, but that "costs associated with retail services" shall "not be included").

51 *AT&T Opposition* at 8.

52 Reply of BellSouth, SBC, and Verizon to AT&T's Opposition to Joint Petition for Reconsideration of Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286, filed May 28, 2002, at 4-7.

53 BellSouth Initial Comments to the Joint Conference Public Notice, (*BellSouth Comments*) at 11.

systems and procedures.[54] ARMIS reports cover a 12-month period and do not require monthly, journalized costs.

In summary, wholesale and retail data are important in assessing ILEC compliance with its duty "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers."[55] Wholesale and retail data are used in determining the appropriate discount for setting resale rates. With the requirement to resell wholesale services at a discount, data is needed regarding retail costs and what costs will be incurred when providing wholesale services.[56] ILEC retail services available for resale are priced on a wholesale basis. Wholesale prices are determined on the basis of subscriber retail rates, excluding portions attributable to marketing, billing, collection, and other costs that will be avoided by the ILEC. Avoided costs are included in Account 6623, Customer Services.[57] The Commission should be guided by its existing rules regarding the determination of avoided retail costs in setting wholesale rates.[58]

Additionally, wholesale and retail data are used in determining the appropriate mark-up for joint and common costs in determining UNE rates.[59] TELRIC pricing of UNEs looks to "forward-looking economic cost-based pricing," but UNE pricing also reflects common costs, loading factors and other overhead costs attributable to the costs of operating a wholesale network. Wholesale costs are routinely assessed by reviewing ARMIS accounts based on the theory that historical ratios of such costs to investment may serve as a proxy (or at least a starting point) for estimating forward-looking cost levels.

The wholesale/retail breakdown for Accounts 6621, Call Completion Services (operator services) and 6622, Number Services (directory assistance) are not necessary because these services are not required to be offered at UNE rates.[60] Nonetheless, ILECs did not provide

---

[54] *AT&T Opposition* at 7. *See* also, *Phase II Report and Order* at para. 64 and *Local Competition Order* (explaining that "directly attributable costs" are relevant to pricing of UNEs, but that "costs associated with retail services" shall "not be included.").

[55] 47 U.S.C. § 251(c)(4)(A).

[56] *See Wisconsin Phase II Comments*, December 21, 2000, at 7 and Attachment A.

[57] Reply Comments of the Public Utilities Commission of Ohio in CC Docket Nos. 00-199, 97-212, 80-286, and 99-301 in the *Phase II Further Notice*, at 8.

[58] 47 C.F.R. § 51.609 (d). In determining avoided costs, the Commission requires that the direct costs recorded in the services accounts (Accounts 6621, 6622, and 6623). Indirect costs may be included in wholesale prices only to the extent that the ILEC proves to a state commission that specific costs in these accounts will be incurred and are not avoidable with respect to services sold at wholesale, or that specific costs in these accounts are not included in retail prices of resold services.

[59] *See Wisconsin Comments* at 7-8. For example, the Wisconsin Commission found in a SBC UNE proceeding that costs incurred regarding product definitions necessary to comply with the FCC rules were competition implementation costs. While SBC proposed that these costs be borne solely by wholesale customers as joint costs, the Wisconsin Commission determined that these costs should be considered as common costs and shared by all users of the network.

[60] *See USTA Comments* at 5.

substantive evidence that it would be burdensome to provide a wholesale/retail breakdown for only Account 6623, Customer Services.

The Joint Conference recommends that the FCC reconsider its Phase II decision and seek comment on other measures that could be used to achieve the *Phase II Report and Order* goals of recognizing an increased importance of the wholesale versus retail distinction as competition develops in the local exchange market and assisting the states in developing UNE rates that properly reflect the costs of providing a wholesale service. ILECs should be requested to quantify the burdens associated with each alternative.

The Commission should seek comment on consolidating of Accounts 6621, Call Completion Services (operator services), and 6622, Number Services (directory assistance), into one account and retaining Account 6623, Customer Services, as a separate account. Regarding the creation of separate wholesale and retail subaccounts, the Commission should request comment on whether modifying ARMIS Report 43-02 to require the reporting of the wholesale/retail percent of customer services expense (Account 6623) would provide sufficient information in determining costs of providing wholesale services rather than creating the new subaccounts in the Part 32[61] accounting rules. Because ARMIS Report 43-02 is reported on an operating company basis, ILECs should be required to report the wholesale/retail percent on an individual state basis. The wholesale/retail percentage would be determined annually on a study basis ILECs already use in UNE proceedings and in keeping with the requirements of section 51.609.[62] This will provide information used in determining UNE rates, developing the discount for resale rates, as well as information regarding competition without the burdensome requirement of maintaining separate subaccounts and the need to separately journalize retail and wholesale components.

If wholesale/retail subaccounts are created, the Commission should seek comment whether the new subaccounts should be applicable only to Account 6623, Customer Services, since UNE rates are not required for operator services and directory assistance. In this case, a determination of what constitutes a wholesale and retail cost is needed. The FCC should seek comment on how to define and distinguish wholesale and retail customer services costs.

C. Consolidation Of Accounts 6561-6565 Into One Depreciation And Amortization Expense Account (6562)

Issue: Should the FCC reverse its decision to consolidate Accounts 6561-6565 into one Depreciation and Amortization Expense Account?

Recommendation: Yes. The Joint Conference recommends the FCC seek further comment related to the consolidation of these accounts and any possible adverse effects on potential rate proceedings at the state commissions.

---

[61] 47 C.F.R. Part 32.

[62] 47 C.F.R. § 51.609.

The USOA continues to be an essential regulatory tool for local, access, and UNE rate setting, price cap regulation, earnings monitoring, and or rate-of-return (ROR) proceedings for ILECs. Data compiled from records maintained in accordance with the USOA are used as the basis for all federal and state proceedings involving tariffs and costs for regulated carriers.[63] Where there is minimal to no competition, competitive forces alone will not govern the marketplace; therefore it may be necessary to continue regulation until competition forces declining prices.

The analysis of costs and determination of rate base sometimes differ between jurisdictions. As a result, segregation of the depreciation and amortization accounts continues to be needed by the states.[64] For example, the treatment of Property Held for Future Use, Account 6562, is often very contentious in a state ratemaking proceeding. For this reason, these expenses should be segregated rather than combined with other depreciation and amortization accounts. Maintaining these expenses in separate accounts while there remains a need for specific detail will be less burdensome than attempting to generate the data on a case-by-case basis.[65] The data will also be available on a timely basis, thereby allowing the FCC, states, and or court proceedings to move forward.

Although many jurisdictions have adopted various forms of alternative regulation to ROR, the fact is that some alternative regulation plans are earnings based, or require refunds, or provide options of returning to the ROR methods if price caps prove to be ineffective. The Commission should therefore re-establish the separate depreciation and amortization accounts (6561-6565) that were consolidated by the *Phase II Report and Order*.

D. Addition Of Accounts

Issue: Should the FCC modify its Part 32[66] Rules to add the following separate accounts?

Optical Switching
Switching Software
Loop and Interoffice Transport
Interconnection – Revenue (with subaccounts for UNE's, Resale, Reciprocal Compensation and Interconnection Arrangements)
Universal Service Support Revenue
Universal Service Support Expense

---

[63] Comments of the National Telecommunications Cooperative Association, filed January 31, 2003, (*NTCA Comments*) at pp. 2-3.

[64] *Wisconsin Comments* at p. 6.

[65] *BellSouth Comments* at pp. 8-9. BellSouth continues to maintain its Chart of Accounts so that depreciation and amortization expenses can be identified for state reporting purposes, but does not believe Price Cap companies should be required to report this detail in ARMIS.

[66] 47 C.F.R. Part 32.

Recommendation: Yes. The Joint Conference recommends the FCC revise the USOA to add these accounts, with clarification that the Universal Service accounts would be used only to record interstate amounts. If the USOA is to be applied to non-ILECs, consideration should be given to adoption of separate accounts for other interconnection expense items.

In *the Phase II Report and Order*, the FCC rejected requests made by several states and interested parties to add certain accounts to the Part 32[67] USOA. The FCC determined that the requested new accounts are either not needed, premature this time or are encompassed in other reporting mechanisms. The FCC reasoned that the burden of keeping the new accounts would outweigh their usefulness to regulators.

The Joint Conference recommends the FCC revise its accounting system to incorporate significant changes in industry structure and regulation as they occur. Consistent with the ongoing implementation of local competition and changing ILEC business models, new accounts should be established to recognize investments in optical switching and switching software, as well as revenues and costs for items such as UNEs, collocated facilities, interconnection agreements, reciprocal compensation, and universal service fund transactions.[68] Such information will enhance the ability of regulators to understand how these items affect the overall ILECs' financial picture.[69]

Without the FCC requiring these accounts, the ILECs may claim the information is not available or will argue that because the FCC doesn't require the accounts, the states should not require them either. Establishing requirements for these accounts either at an individual state level or even a regional level will not be easy. Some states are locked into following the FCC USOA, so they would be precluded from such a venture. Additionally, collecting the information on an individual state or regional basis raises the concern of uniformity and consistency of the data among the states.

The information recorded in the requested accounts will enable the FCC and states to continue to understand the nature of the ILECs' investment and ensure that prices are reflective of their actual costs. The information will allow the monitoring of technology deployment, collocation, and interconnection cooperation. An additional benefit will be the usefulness to states in setting policy direction. Moreover, the addition of these accounts would help states and the FCC better understand the status of local competition and enable regulators to take steps to address issues that may be relevant to the state of competition.[70] Each account is more particularly discussed below.

---

[67] *Id.*

[68] Comments of the North Carolina Utilities Commission – Public Staff, filed January 31, 2003, (*NCUC Staff Comments*) at 2-3.

[69] *Id*.

[70] Comments of the Florida Public Service Commission Regarding Accounting Issues, WC Docket No. 02-269, filed January 31, 2003, (*Florida Comments*) at 3.

1. Optical Switching

Use of an Optical Switching account will provide data regarding the extent of deployment of new technology. There may also be future concerns concerning depreciation rates associated with new technologies.[71] The current level of deployment of optical switches is only one relevant factor when assessing whether to require the reporting of such information, and other factors mitigate strongly in favor of adding a separate optical switching account.[72] ILECs and states often look to historical switched costs in estimating forward-looking costs for UNEs. It is therefore important to separate the costs of the various technologies to ensure informed decision-making.

ILECs presumably already keep track of this information, just as they do for non-optical switches. Additionally, to the extent that there are only a few optical switches deployed, collecting that information should not be overly burdensome.[73] If new technologies are indeed subject to shorter economic lives, as the ILECs claim, establishing this account will be of benefit to the ILECs.

State commissions rely on the FCC Part 32[74] accounting data in carrying out federal requirements, such as determining universal service cost levels and UNE prices.[75] It is important that the accounting system provide investment figures for all of the new technologies. This is essential so states can assess the extent to which the carriers are modernizing their networks in individual states. While there may be other sources of carrier network modernization data, the accounting data is an important check on all the others and it is more reliable in many ways. For example it is typically the only data that the carriers file that must be audited.

2. Switching Software

There is substantial regulatory need for separate accounting for software investment. The magnitude of switching software warrants separate accounting. Some switching software is capitalized, and some is expensed.[76] As noted in the *Wisconsin Comments*, the Wisconsin Commission found in its SBC UNE pricing docket that the determination of traffic sensitive versus non-traffic sensitive investment and costs may vary from company to company based on the manner in which a particular company incurs its costs.[77]

---

71 *Wisconsin Comments* at 11.

72 *AT&T Comments* at 15.

73 *Id*. at 16.

74 47 C.F.R. Part 32.

75 WorldCom Comments, WC Docket No. 02-269, filed January 31, 2003, (*WorldCom Comments*) at 27; Reply Comments of AT&T Corp., WC Docket No. 02-269, filed February 19, 2003, (*AT&T Reply Comments*) at 10.

76 *Wisconsin Comments* at 11.

77 *Id.* at 11-12.

AT&T notes that in recent state UNE proceedings and federal 271 proceedings and in universal service cost model proceedings, ILECs have begun to argue that existing and new switching software has a significant impact on switching costs. The only way to determine whether these claims are legitimate, and to assess the impact of those costs on UNE rates and the universal service mechanism, is to require ILECs to maintain that information separately. Judging by ILEC arguments in ILEC 271 proceedings, ILECs already maintain such information, so it should not be unduly burdensome.[78] BellSouth states that it maintains separate subsidiary records for general purpose and network software.[79] Thus, reporting this information in a separate account should not be cost prohibitive.

3. Loop And Interoffice Transport

Contract prices and model algorithms are inputs needed to determine compliance with TELRIC pricing standards. To the extent ILECs claim that UNE rates do not cover accounting costs, data separating loop costs from transport costs is needed to make comparisons to accounting costs. Additionally, if separate wholesale and retail companies are created, separate data for loop versus transport costs may be needed to develop transfer prices.[80]

4. Interconnection Revenue (with subaccounts UNEs, Resale, Reciprocal Compensation, and Other Interconnection Arrangements)

Sources of revenue appear to be one of the more important components necessary to monitor the transition to a competitive marketplace. This data will be of value in assessing how the interconnection processes further the development of local competition. For example, if such revenues are minimal, it could mean that UNE rates are too high. If such revenues remain minimal it could mean that the interconnection regime is not a fertile area for local competition and that state resources need to be deployed in other pro-competitive areas. Other data sources are inadequate (e.g., data requests in the FCC's local competition proceeding), because accounting data is still the only audited data and, in any case, is essential to understanding the extent of the activity. The FCC reasoned that such accounts are unnecessary in light of existing requirements that perform the same or similar function.

With respect to interconnection-related expenses, the FCC chose to rely on the statutorily created obligations on ILECs under sections 251 and 252 to document these costs.[81] However, considering those created obligations are the subject of review and possible termination in FCC WC Docket 02-112,[82] it is more imperative that new accounts be established to assure this data is maintained.

---

78 *AT&T Comments* at 16.

79 *BellSouth Comments* at 20.

80 *Wisconsin Comments* at 12.

81 47 U.S.C. §§ 251 and 252.

82 *In the Matter of Section 272(f)(1) Suncset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112.

Form 477[83] data is not adequate. The FCC Form 477 does not include any interconnection revenue or expense data. While some data relates to local competition (e.g., number of UNE loops), none of the data is audited, calling the reliability of the data into question. The Form 477 does not collect comprehensive data on all interconnection activities (e.g., the only UNE data collected on Form 477 is UNE loop data and there are many other types of UNEs offered). Accounting data is essential to understand the nature of the competition (e.g., is it healthy, is there resale activity and at what level). Form 477 data is confidential, resulting in delays for states in obtaining access to the data and making other state's data unobtainable. Further, given its confidentiality, it will be difficult for states to use the data in a hearing or publicly issued decisions.

As universal service funds expand in order to make implicit subsidies explicit in nature, information in this area is likely to increase in importance.[84] Revenue flow is highly CLEC to ILEC in nature. It is less likely that an ILEC will buy unbundled access to a CLEC's network or will resell a CLEC's services. Additionally, an ILEC is not likely to collocate in a CLEC's central office. Interconnection accounts would assist states in assessing local competition and whether such competition is getting a foothold in their states. This data could prove useful to states in formulating policy. The addition of these accounts would clearly help the states and the FCC better understand the degree of local competition and enable regulators to take steps to address issues that may be relevant to the state of local competition.

The current USOA appears to support classification of interconnection expenses in Account 6540, Access Expense. Reciprocal compensation is an expense associated with local service, whereas access expenses are related to long distance service. A separate account or subaccount is needed for an ILEC's reciprocal compensation paid to other entities. As noted by NASUCA, in Ohio, the carrier that is the recipient of the greatest amount of federal high cost universal service support currently includes that amount in Account 5082, Switched Access Revenue. This account is allocated entirely to the interstate jurisdiction, despite the fact that the purpose of this support is to keep local rates low. This particular carrier's local rates are among the highest in the state.[85]

ILEC arguments concerning the availability of data are overstated. BellSouth states that interconnection revenues are identifiable within its accounting system and are routinely provided to state commissions in regulatory proceedings. The revenues are journalized to the revenue accounts corresponding to the services being sold but they can be identified through underlying accounting codes. BellSouth asserts that to record resale revenues in one account would require reprogramming of accounting systems and also require changes to Part 36[86] separations process and procedures. According to BellSouth, UNE and local reciprocal compensation revenues are currently recorded as miscellaneous revenue in Account 5200 and are separately identifiable.

83 FCC Form 477 – Local Competition and Broadband Reporting.

84 *Wisconsin Comments* at 12.

85 *NASUCA Comments* at 15.

86 47 C.F.R. Part 36.

Because these revenues can be ascertained through its current accounting systems, BellSouth argues there is no need to require new accounts that would be costly to implement and would provide no discernable benefit.[87] However, this information is not publicly filed and therefore not accessible to interested parties such as consumer advocates.[88]

5. Universal Service Support

New USF accounts are needed to understand the federal USF programs and the effect these programs have on consumers because data of ILEC USF costs from FCC Form 499A[89] is inadequate. With no specific accounts assigned, USF revenue and expenses will be included in other accounts (such as access revenue and expense) where they will distort the data. Furthermore, Form 499A does not require reporting on a state basis, rather such data is filed by operating company. For multi-state companies (such as Verizon, SBC, BellSouth) the data is not available by individual state. While having both interstate and intrastate USF accounts would provide the most usefulness to state regulators, the Joint Conference recognizes the difficulties that could be encountered with differences in state USF support mechanisms and reporting procedures. Therefore, at this time, the Joint Conference will limit its recommendation to establishing accounting requirements for the federal USF program only. The effect on carriers will be minimal, and the information will provide valuable information in assessing the workings of the federal USF.

V. AFFILIATE TRANSACTIONS REQUIREMENTS

A. Elimination Of The Requirement For Fair Market Value Comparison For Asset Transfers Below $500,000

Issue: Should the FCC reverse its decision to eliminate the requirement for a comparison between net book cost and fair market value for the first $500,000 of asset transfers?

Recommendation: No. The Joint Conference recommends that the FCC affirm its decision as announced in the *Phase II Report and Order*.

The Phase II decision eliminated the requirement that carriers make a fair market value comparison for assets when the value of assets transferred is below $500,000.[90] By eliminating this requirement, carriers will no longer be required to perform a net book cost/fair market value comparison for the first $500,000 of asset transfers. Rather the asset will be recorded at net book cost. Previously, a comparison was performed on a product-by-product basis, per year, per affiliate. In the *Phase II Report and Order*, the FCC defended this change by noting that it

---

[87] *BellSouth Comments* at 17-18.

[88] Reply Comments of the National Association of State Utility Consumer Advocates, WC Docket No. 02-269, filed January 29, 2003, (*NASUCA Reply Comments*) at 4.

[89] FCC Form 499A – Telecommunications Reporting Worksheet.

[90] *Phase II Report and Order* at para. 90.

would promote symmetry with the current treatment of transactions involving services, effectively eliminating any incentive for companies to turn "assets" into "services."[91]

This change did not garner any opposition from interested parties in response to the *Joint Conference Public Notice*.[92] In support, ILECs contend the change is inconsequential.[93] BellSouth noted that, from January to October 2002, asset transfers that fell within the parameters of the rule as revised totaled $1.3 million. That total equates to approximately 4% of all asset transfers, and 0.005% of BellSouth's net fixed assets.[94]

The Wisconsin Commission specifically supports the change as set forth in the *Phase II Report and Order*, agreeing that the treatment of services and assets should be symmetrical for such small transactions.[95]

B. Establishment Of Floor And Ceiling For Recording Transactions

Issue: Should the Commission reverse its decision to allow ILEC discretion in valuing affiliate transactions as long as the valuation complies with a prescribed floor or ceiling?

Recommendation: Yes. The Joint Conference recommends that the FCC reverse its decision to permit ILECs to have such discretion in valuing affiliate transactions.

In its *Phase II Report and Order*, the FCC revised its affiliate transaction rules to permit carriers to use the higher or lower of cost or market valuation as either a floor or ceiling when valuing transactions.[96] Prior to this change, where a carrier was the recipient of an asset or service, that asset or service was required to be recorded on the carrier's books at the lower of cost[97] or fair market value (FMV). If the carrier provided the asset or service, the carrier valued the transferred asset or service at the higher of cost (FDC or NBC) or market value. The change approved in the *Phase II Report and Order* allows carriers to assign whatever value they deem appropriate for a transaction, as long as the value falls within the parameters of the adopted floor and ceiling. The effect of this rule change is to allow carriers greater flexibility in valuing these transactions.[98]

---

91 *Id*.

92 *See, Joint Conference Public Notice*.

93 *See, BellSouth Comments* at pp. 13-14; *Verizon Comments*, Appendix at p. 1.

94 *BellSouth Comments* at 13.

95 *Wisconsin Comments* at 12.

96 *Phase II Report and Order*, paras. 91-92.

97 Generally, "cost" is the fully distributed cost (FDC) when valuing services and the net book cost (NBC) when valuing assets.

98 The FCC offered the following example: If an ILEC were buying an asset with a NBC of $750,000, and a FMV of $1,000,000, the rules prior to the *Phase II Order* required the ILEC to record the asset at $750,000, which is the lower of cost or market. The change adopted by the FCC permits the carrier to record the asset, purchased from one of its non-regulated affiliates, at any valuation up to the ceiling of $750,000 (the lower of NBC and FMV). Arguably, the ILEC could choose to record the transaction at a value of $0. *See, Phase II Report and Order,* n. 172.

In its *Phase II Report and Order*, the FCC concluded that this change "would not harm ratepayers because it would permit the regulated carrier to either pay less or charge more to the nonregulated affiliate for the service or asset."[99] While acknowledging that the change could "potentially have an anti-competitive effect," the Commission found this possibility unlikely, "particularly if the transaction is *de minimus* and is not priced below incremental cost.[100]

As the FCC recognized, allowing a carrier the flexibility of choosing a valuation that falls within the parameters of a floor and ceiling opens the door to anti-competitive behavior.[101] It allows the ILEC to record a purchased asset or service at a very low value when, had the purchase been made in the open marketplace, the price would have been considerably higher. Such an under-valuation could result in prices that are artificially low and are not cost based. A competitor could not arbitrarily choose the value to be recorded for a similar purchase and would therefore be at a competitive disadvantage due to the ILEC's lower prices. In addition, the discretion afforded by the rule would permit ILECs to value assets or services they purchase from a nonregulated affiliate at levels much lower than true cost or market value. The rule, as adopted, applies to all transactions, not just small ones, and confers on the ILEC the discretion to choose any price that is below the ceiling, without consideration being given to the incremental cost. Conversely, a carrier could record an exaggerated price for the sale of an asset or service, which in turn would permit an ILEC to value assets or services sold at levels much higher than the true cost or market value.

ILECs have argued that the new provisions for establishing floors and ceilings in valuing assets and services affords them appropriate flexibility to avoid calculating all the elements of fully distributed cost and to avoid estimating fair market value.[102] However, allowing this type of flexibility permits too much discretion in the valuing of affiliate transaction by an ILEC. A comparison with cost or fair market value should remain the touchstone of valuing these transactions. The unfettered discretion afforded by the newly approved floor and ceiling provisions of the Commission's rules provides unrestrained opportunities for manipulation of costs, revenues, and earnings – precisely the type of problems that gave rise to this Joint Conference.

C. Prevailing Price Treatment Threshold

Issue: Should the FCC reverse its decision in the *Phase II Report and Order* and return the threshold required to qualify for prevailing price valuation of affiliate transactions to 50 percent of sales of a particular asset or service to third parties?

Recommendation: Yes. The threshold should be returned to 50 percent.

---

99 *Id*. at para. 92.

100 *Id*.

101 *Id*.

102 *BellSouth Comments* at pp. 14-16; *Verizon Comments*, Appendix, p. 1.

Prevailing price valuation permits ILECs to value sales of assets and services without establishing the cost or fair market value, but rather based solely on the price of that asset or service when sold to the general public (*i.e.*, a non-affiliated third party). Adopting a USTA proposal, the *Phase II Report and Order* reduced the threshold to qualify for prevailing price valuation from 50 percent to 25 percent of sales of a particular asset or service to third parties. The FCC explained that the purpose of the threshold is to ensure that sufficient transactions take place with the general public, as opposed to merely with the affiliate, to "produce a reasonable surrogate of a true market price."[103] The FCC concluded that it would unlikely be "a sustainable strategy for a firm significantly to under-price transactions with 25 percent of its customers in order to be able to record transactions at this price with an affiliate."[104]

The *Phase II Report and Order* reflects the assumption that there are no situations in which an ILEC would under-price 25% of the sales of a good or service to third parties in order to gain the benefit of below cost pricing to affiliates for the remaining 75% of sales of that good or service. However, it is not uncommon for parties in commercial relationships to exchange mutual concessions in the sales of goods and services.

For example, ILECs frequently enter into partnership agreements and other contractual relationships with nonaffiliated third parties (*e.g.,* SBC partners with Yahoo for Internet access service) in which it could be advantageous for the ILEC to provide an asset or service to the third party at a favorable, below cost price. The ILEC may receive a similar concession on a product or service provided by the third party. In such a situation, an ILEC could strategically under-price a relatively small amount of a particular service or asset to gain an offsetting concession from the third party, and at the same time confer on its affiliate a competitive advantage. By under-pricing services or assets, the ILEC would be absorbing some of the cost and thereby lowering the affiliate's overall cost structure, to the overall benefit of the ILEC's holding company.

Additionally, ILECs could use this new discretion to offset higher-than-desired earnings at the regulated entity. This would be an advantageous strategy whenever an ILEC believes it would benefit from making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement.

D. Modification Of The Centralized Services Exception To The Estimated Fair Market Value Rule

Issue: Should the FCC eliminate the centralized services exemption to the affiliate transactions rules?

---

[103] *Phase II Report and Order* at para. 94.

[104] *Id*.

Recommendation: Yes. The FCC should eliminate the centralized services exception to the affiliate transactions rules, thereby making such transactions subject to the general rule requiring fair market value analysis.

In a 1996 decision, the FCC created an exception to the valuation rules, for transactions involving affiliates that provide services solely to members of the corporate family.[105] The exception, called the centralized services exception, permits carriers to value services provided by such centralized services affiliates at fully distributed cost without demonstrating that this cost is below fair market value. In the *Phase II Notice*, at the behest of USTA, the FCC asked whether it should expand the centralized services exception to either apply on an individual service basis (i.e., when an affiliate provides a variety of services to both family members and third parties, but provides one particular service just to family members) or to apply to entities that exist primarily to serve members of the carrier's corporate family (i.e., most, but not all, of the affiliate services are provided to family members) . The FCC declined to expand the exception in the *Phase II Report and Order*.[106]

The *Phase II Report and Order* rejected the proposed expansion of the centralized services exception because of the risk that the affiliate would improperly shift costs to the regulated carrier.[107] The FCC identified a variety of reasons why cost shifting from affiliates to regulated entities would be potentially harmful to ratepayers and beneficial to ILECs.[108]

There were no ILEC petitions for reconsideration or requests to reverse the Phase II decision with respect to this issue. The Phase II decision's analysis on this issue is sound.

The discussion of the centralized services exception in the *Phase II Report and Order* raises the larger issue of the appropriateness of the exception at all. The centralized services exception requires the regulated carrier to record fully distributed cost as the cost of any service the carrier receives from the centralized services affiliate, without making any determination that the fully distributed cost is less than the fair market value of the services. As noted above, the general rule for recording the cost of an asset the carrier receives from its affiliate is that it must be recorded at the lower of market or book value. In its 1996 decision creating the centralized services exception, the FCC stated that the services provided by the centralized services affiliate might in many instances be unique and not readily capable of determining an accurate fair market value. The FCC also opined that centralized services affiliates are created to enable corporate families to obtain economies of scale and scope and that fair market valuations would increase costs with little accompanying benefit.[109] The FCC did not consider this issue during the Phase 2 proceedings.

---

105 *Re Implementation of the Telecommunication Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Report and Order, 11 FCC Rcd. 17,539, FCC 96-490 (rel. December 23, 1996) (*Accounting Safeguards Order*).

106 *Phase II Report and Order* at para. 98.

107 *Accounting Safeguards Order* at para. 98.

108 *Id*. at para. 99.

109 *Id*. at para. 148.

The Commission's 1996 decision creating the exception should be revisited in light of the concerns raised by the accounting scandals of recent years. The exception confers on the carrier and its holding company the opportunity to have the carrier pay in excess of market prices for services obtained from an affiliate. The corporate family is not harmed by such overpayments as the holding company is unaffected by intra-holding company transfers. However, the regulated carrier may find it advantageous to show artificially high costs and, as a result, depressed earnings. One of the goals of the Joint Conference is to limit opportunities for carriers to manipulate their financial statements. Eliminating the exception will further this goal.

In addition, regulated carriers that record excessive costs for services from an affiliate can use those costs to justify excessive wholesale or retail rates. Affiliate transaction rules should not permit carriers to use transactions with affiliates to justify artificially high costs that are then passed on to competitors or end users buying services for which the ILEC retains market power. The *Accounting Safeguards Order* does not explain why a carrier with market power would not have the opportunity to take advantage of the exception to justify unduly high wholesale or retail prices.

E. Exemption Of Nonregulated To Nonregulated Transactions From The Affiliate Transactions Rules

Issue: Should the FCC continue to defer action on whether nonregulated to nonregulated transactions should be exempted from the affiliate transactions rules?

Recommendation: Yes. The Joint Conference recommends that the FCC maintain the current reporting requirements for nonregulated to nonregulated affiliate transactions and take no additional action at this time.

Under current rules, when a carrier sells an asset used exclusively in its nonregulated operations to its nonregulated affiliate, the asset must be valued according to the affiliate transactions rules. In the *Phase II Notice*, the FCC asked whether nonregulated to nonregulated transactions should continue to be exempt from the affiliate transactions rules. The FCC deferred action on the proposal, "as it raises broader issues that should be considered in a more comprehensive fashion."[110]

With the increased re-integration into BOCs of affiliates that have previously been separate affiliates (e.g., long distance, advanced services), retention of this rule is necessary to prevent manipulation of costs and revenues associated with affiliate transactions. Such manipulation could be used to distort the overall financial results of regulated carriers, a concern that gave rise to this Joint Conference.

---

110 *Phase II Report and Order* at para. 100.

F. Intra-Holding Company ILEC To ILEC Transfers Of Assets Or Services

Issue: Should the FCC apply its affiliate transaction rules to transactions between ILECs within the same holding company?

Recommendation: Yes. The FCC should clarify that its affiliate transaction rules are equally applicable to transactions between ILECs within the same holding company.

In its comments to the *Joint Conference Public Notice*, AT&T raised the following issue that was not addressed in the *Phase II Report and Order* – whether affiliate transaction rules should apply to transactions between ILECs within the same holding company, e.g., between Verizon-New York and Verizon-New Jersey or SBC's ILEC in Texas (formerly Southwestern Bell Telephone Company) and SBC's ILEC in California (formerly Pacific Bell).[111]

Inapplicability of transfer pricing rules affords an opportunity for ILECs to manipulate their costs, revenue, and earnings in a manner that could lead to inflated wholesale or retail rates or inaccurate reports of earnings by the ILECs. For example, suppose SWBT decides to purchase accounting support services from PacBell. If PacBell sets the price for these services at an inflated level, SWBT would then record the inflated rate as an expense, and PacBell would record the inflated rate as revenue. By merely shifting costs and revenues from "one pocket to the other," the parent company is not harmed by the activity. However, SBC (in this example) can use this loophole to overstate expenses. Overstated expenses can become the basis of cost studies used to set wholesale or retail prices, thereby causing inflated prices to consumers.

The opportunity for cost manipulation could permit a holding company to artificially manipulate earnings among its ILECs as a means of gaming different regulatory issues in different states. For example, if higher earnings in state X would cause more adverse consequences than similar earnings in state Y, the holding company could use affiliate dealings between its ILECs to artificially depress earnings in state X and artificially increase them in state Y. With the large ILEC mergers in recent years (e.g. SBC/Pacific Telesis, SBC/Ameritech, Bell Atlantic/GTE), there is increased opportunity for ILEC to ILEC transactions within a holding company.

Due to the potential asymmetry between fair market value and net book cost/fully distributed cost during a transaction between two ILECs within the same holding company, only one pricing standard can apply. The FCC should clarify that the fully distributed cost/net book value standard applies to transactions between two ILECs.

G. Affiliate Transactions And Section 272

Issue: Should the FCC impose other requirements and accounting safeguards following the elimination of the affiliate and nondiscriminatory requirements of section 272?

---

[111] *AT&T Comments* at 20.

Recommendation: Yes. Following sunset of the structural separation requirements of section 272, the Joint Conference recommends that the BOC be required to maintain separate books of account for the provision of interexchange service and maintain an affiliate that provides in-region interexchange service that is subject not only to accounting review but also to certain safeguards.

The purpose of the separate affiliate and nondiscrimination requirements in section 272 is to lessen the ability of a BOC to discriminate and/or misallocate costs to the advantage of its own operations, and to make it easier to detect any such behavior. Section 272 (a) of the Act requires BOCs to provide in-region, interLATA telecommunications services through separate corporate affiliates, subject to certain safeguards.[112] Section 272 (b) requires that the separate affiliates maintain separate books of account and have separate officers and directors and that all transactions between the section 272 affiliate and the BOC be on an arm's length basis, pursuant to the Commission's affiliate transaction rules.[113] Sections 272 (c) and (e) impose nondiscrimination safeguards on the BOC and require that all transactions with the affiliate be accounted in accordance with the accounting rules designated or approved by the Commission.[114] Section 272 (d) requires the BOC to obtain and pay for a biennial joint federal/state audit after section 271 approval to determine compliance with the structural and transactional requirements of section 272.[115] Section 272(f)(1) provides that the provisions of the section, except for section 272(e), expire three years after a BOC or any BOC affiliate is authorized under section 271 to provide in-region, interLATA services, "unless the Commission extends such 3-year period by rule or order."[116]

In the *Accounting Safeguards Order* and the *Non-Accounting Safeguards Order*, the Commission adopted rules to implement the statutory requirements of section 272.[117] In the *Non-Accounting Safeguards Order*, the Commission concluded that as long as the BOCs retain market power in the provision of local exchange and exchange access services within their service areas, they have an incentive and ability to discriminate against their long distance competitors, and engage in other anti-competitive conduct. The Commission found the BOCs to be dominant carriers with an incentive to discriminate in providing services and facilities that their interexchange competitors need to compete in the interLATA services markets.[118]

---

[112] 47 U.S.C. § 272(a)(2).

[113] 47 C.F.R. § 32.27. Under the affiliate transaction rules, transactions are to be valued at publicly available rates - specifically, a tariffed rate, a rate in a publicly filed agreement or statement of generally available terms, or a qualifying prevailing price valuation - if possible. If there is no such publicly available rate, transfers from the BOC to the affiliate are booked at fair market value or net book cost, whichever is higher. Transfers from the affiliate to the BOC are recorded at fair market value or net book cost, whichever is lower. The BOC may use any reasonable method to determine fair market value; an independent appraisal is not required.

[114] 47 C.F.R. § 32.27.

[115] 47 U.S.C. § 272 (d). *Accounting Safeguards Order* at paras. 184-204.

[116] 47 U.S.C. § 272(f)(1).

[117] *See, Accounting Safeguards Order* and *Non-Accounting Safeguards Order*.

[118] *Non-Accounting Safeguards Order* at para. 85.

Additionally, the *Non-Accounting Safeguards Order* found that the separate affiliate and related requirements of section 272 are "designed, in the absence of full competition in the local exchange marketplace, to prohibit anticompetitive discrimination and cost-shifting."[119]

In the *LEC Classification Order*, the Commission concluded that the BOC interLATA affiliates should be classified as non-dominant in their provision of in-region, interstate and international interLATA services. The decision was predicated on the presence of a section 272 separate affiliate and full compliance with the structural, transactional, and nondiscrimination requirements of section 272 and the Commission's implementing rules.[120] The Commission determined that some level of separation between an ILEC's interstate long distance service operations and its local exchange operations was necessary to guard against cost misallocation, unlawful discrimination, or a price squeeze.[121] The Commission therefore required independent ILECs to provide their in-region, interstate and international interexchange services through separate affiliates that satisfy the separation requirements adopted in the *Competitive Carrier Fifth Report and Order*.[122] In the *Second Reconsideration Order*, however, the Commission relaxed these requirements for independent ILECs providing in-region, interstate and international interexchange services exclusively through resale, by allowing them to do so through a separate corporate division subject to certain safeguards.[123] The *LEC Classification Order* also eliminated the separate affiliate requirements imposed on BOCs and independent ILECs as a condition for non-dominant treatment of their provision of out-of-region, interstate interexchange services.[124]

The Commission currently has an open proceeding which inquires whether the separate affiliate and related safeguards of section 272 should sunset as provided in the statute or be extended by the Commission.[125] The *272 Sunset Notice* also inquires on a range of possible alternative safeguards for BOC provision of in-region, interLATA services after the sunsetting of the statutory requirements under section 272. The FCC's *272 Sunset Further Notice* inquires into the appropriate classification of BOCs' and independent ILECs' provision of in-region, interstate and international interexchange telecommunications services.[126]

---

[119] *Id*. at para. 9.

[120] *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, CC Docket No. 96-149, Second Report and Order, 12 FCC Rcd. 15756, paras. 83, 158-61 (1997) (*LEC Classification Order*).

[121] *Id*. at para. 143.

[122] *Id*. at para. 7.

[123] *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area; Policy and Rules Concerning the Interstate, Interexchange Marketplace*, CC Docket Nos. 96-149 and 99-61, Second Reconsideration Order, 12 FCC Rcd at 10,777, para. 9 (Second Reconsideration Order). ILEC resellers still must maintain separate books of account, comply with affiliate transaction rules, and acquire any services from the exchange company pursuant to tariff.

[124] *LEC Classification Order* at para. 9.

[125] *In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, Notice of Proposed Rulemaking, FCC 02-148, (rel. May 24, 2002) (*272 Sunset Notice*).

[126] *See In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements; 2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules,* WC

The section 272 safeguards are designed to reveal and discourage BOC subsidization of their long-distance affiliates by recovering the affiliates' costs from local and exchange access customers. The 272 structural affiliate requirement is a mechanism to control cost shifting in the form of misallocation of joint and common costs by forbidding joint operations and joint marketing. The Commission noted in the *272 Sunset Notice* that maintaining a separate affiliate creates a more transparent record of transactions between the BOC and its affiliate, thereby facilitating detection of discriminatory behavior.[127] In the absence of those safeguards, the possibility of cross-subsidization is heightened.[128] The Commission found in the *Accounting Safeguards Order* that as long as the BOC, through its control of bottleneck facilities, has dominance over local exchange and exchange access service, there is an incentive for cross-subsidization.[129] Moreover, the Commission made clear in the *LEC Classification Order* that its existing non-dominant treatment of the BOC long-distance affiliates was "predicated" on the existence of section 272.[130]

In the *Accounting Safeguards Order*, the Commission relied extensively on the existence of the structural safeguards, audit requirements and affiliate transaction requirements of section 272 to support its finding that there are sufficient safeguards to prevent the BOCs from eliminating competing IXCs by engaging in improper cost misallocation.[131] When the 272 structural affiliate requirements and nondiscriminatory safeguards are eliminated, the separate structural requirement will dissolve. The integration of the BOC's local operations with its interLATA activities will increase the risks of cost shifting. For example, an ILEC could use profits from vertical features such as call waiting, call forwarding, and caller ID to subsidize low long-distance rates. Without safeguards, the BOC could subsidize its more competitive long distance services by over-pricing local services.

In the *Competitive Carrier Fifth Report and Order*, the Commission concluded that independent ILEC provision of interstate, domestic, interexchange services is subject to non-dominant treatment if such services are offered through an affiliate that meets certain requirements.[132] While the separation requirements do not require actual structural separation, the affiliate must: (1) maintain separate books of account; (2) not jointly own transmission or switching facilities with the exchange telephone company; and (3) obtain any exchange telephone company services at tariffed rates and conditions.[133] Except for the ban on joint

---

Docket No. 02-112 and CC Docket No. 00-175, Further Notice of Proposed Rulemaking, (rel. May 19, 2003) (*Further 272 Sunset Notice*).

[127] *272 Sunset Notice* at para. 22.

[128] *In the Matter of Extension of Section 272 Obligations of Southwestern Bell Telephone Co. In the State of Texas*, WC Docket No. 02-112, Petition of AT&T Corp. at 8-9.

[129] *Accounting Safeguards Order* at para. 14.

[130] *LEC Classification Order* at para. 82.

[131] *Accounting Safeguards Order* at paras. 59-60.

[132] *Competitive Carrier Fifth Report and Order* at para. 9.

[133] *Id*. The Commission concluded that any interstate, interexchange services offered directly by an ILEC or

ownership of transmission and switching facilities, the independent ILEC and the interexchange affiliate can share personnel and other resources or assets. Thus these separation requirements are less extensive than the structural separation requirements of section 272.

To guard against possible cross-subsidization and improper cost allocation, safeguards are needed when section 272 obligations sunset. The Joint Conference recommends that the BOCs' provision of in-region long distance services that are no longer subject to section 272 affiliate requirements should be subject to certain safeguards. The Joint Conference recommends the Commission:

1. Require BOCs to establish an affiliate for the provision of interexchange services that follows, at a minimum, the requirements set forth in Part 64.1901-1903 of the Commission's rules for independent ILECs. These less stringent structural separation requirements will enable regulators to monitor the effect of transactions after release from the section 272 obligations.

2. Retain biennial audit requirements. A federal/state joint biennial audit should be required to enable regulators to detect cross-subsidization or discriminatory behavior.

VI. REPORTING REQUIREMENTS AND OTHER ISSUES

A. Collection Of Local Loop Facilities Data As Loop Sheath Kilometers

Issue: Should the FCC reverse its decision to require the collection of Local Loop Facilities data as Loop Sheath Kilometers?

Recommendation: The Joint Conference takes no position on the addition of loop sheath kilometers to ARMIS Report 43-07. However, if the requirement is retained, the FCC should also retain the existing "Sheath Kilometer" reporting requirement for some period of time.

Total Sheath Kilometer information is useful as it identifies the infrastructure for loop and interoffice, combined, for a particular ILEC. In the *Phase II Report and Order*, the Commission found:

> In the first section of Table II, "Sheath Kilometers," carriers report data on transmission facilities within their operating areas. Carriers use either analog or digital technology on copper wire, coaxial cable, fiber, radio, and other media. In the Notice, the Commission proposed to change the title "Sheath Kilometers" to "Loop Sheath Kilometers" to narrow the collection of data to only local loop facilities connecting customers to their serving offices.[134]

---

through an affiliate that did not satisfy the separate affiliate requirements specified in the *Competitive Carrier Fifth Report and Order*, would be subject to dominant carrier regulation. The Commission also proposed to regulate any future provision of interLATA services by the BOCs as dominant, until the Commission determined what degree of separation, if any, would be necessary for the BOCs or their affiliates to qualify for non-dominant regulation.

[134] *Phase II Report and Order* at para. 170.

The stated rationale for the change appears to be that the FCC "conclude[d] that this information would be more useful for policymakers and interested parties if it were narrowed to local loop facilities connecting customers to their service offices. Therefore, we now change the title to "Loop Sheath Kilometers" and limit the collection of data to local loop facilities."

B. Broadband Infrastructure Reporting

Issue: Should the FCC reconsider its Phase II decision regarding broadband infrastructure reporting?

Recommendation: No. The Joint Conference recommends the FCC deny the *Joint Petition for Reconsideration* regarding the reporting of broadband infrastructure data in ARMIS Report 43-07. Notwithstanding this, the reporting of broadband infrastructure data should continue to be evaluated as to whether the data collection should be expanded to a larger universe of carriers.

ARMIS is an automated reporting system developed by the FCC to collect financial, operating, service quality, and network infrastructure information that ILECs are required to collect under FCC rules. Specifically, ARMIS Report 43-07 (Infrastructure Report) collects information about the physical and operating characteristics of the ILECs.[135] ARMIS Report 43-07 collects data about the carrier's switching and transmission equipment, call set up time, and cost of total plant in service. This report is filed on a study area and holding company level. The report captures trends in telephone industry infrastructure development under price cap regulation. Policymakers at the federal and state levels use this information, which is critical data not available through other public sources.

In the *Phase II Notice*, the FCC sought comment on adding information on hybrid fiber-copper loop interface locations, number of customers served from these interface locations, xDSL customer terminations associated with hybrid fiber-copper loops, and xDSL customer terminations associated with non-hybrid loops to the ARMIS Report 43-07.[136] The *Phase II Report and Order* concluded that the addition of this information to ARMIS would help to "satisfy an immediate and pressing need to assess the penetration of fiber in the local loop and gauge the development of broadband infrastructure."[137] The FCC recognized that hybrid architectures will likely become increasingly important in providing broadband services and are directly relevant to current criticisms by new entrants that the new architectures are systematically diminishing their ability to provide competing DSL service to end-user retail customers. The FCC therefore found that there is a present federal regulatory need, at least for the near term, to collect such data to evaluate the effects of public policy decisions and to consider whether more market-oriented approaches are appropriate.[138] However, comment was

---

[135] The ARMIS Report 43-07 – Infrastructure Report, is required for 30 mandatory price cap incumbent ILECs.

[136] *Phase II Notice* at para. 74.

[137] *See, Phase II Report and Order* and *Phase II Further Notice*.

[138] *Phase II Report and Order* at para. 175, nn. 332-335.

sought in the *Phase II Further Notice* on whether the additional broadband information should be collected as part of Form 477, rather than through ARMIS.[139]

In their *Joint Petition for Reconsideration*, BellSouth, SBC, and Verizon (collectively, Petitioners) support the FCC's gathering of information regarding broadband infrastructure. However, the Petitioners argue that this information should be reported on Form 477, rather than through ARMIS, citing the need to protect confidential, proprietary information and avoid duplicative and potentially inconsistent reporting requirements.[140] The Petitioners assert that by ordering data regarding broadband infrastructure to be reported through ARMIS, the FCC has effectively ordered certain Class A carriers to be the sole public reporters of broadband information. This, they argue, is unequal regulatory treatment giving cable broadband providers and other competitors a regulatory advantage.[141] Finally, the Petitioners request that the FCC defer implementation of reporting the fiber and xDSL deployment information in ARMIS Report 43-07 until an order has been issued in the *Phase II Further Notice.*

In response to the *Joint Petition for Reconsideration*, AT&T asserts that the Petitioners' argument, that fiber and xDSL deployment information reported in ARMIS Report 43-07 warrants confidential treatment, is misplaced. AT&T claims that the ARMIS data will be collected and reported only at the study area level and thus would not provide potential competitors with competitively sensitive information. Nonetheless, AT&T notes that nothing precludes carriers from seeking confidential treatment of information provided in ARMIS reports. It is the contention of AT&T that "the mere fact that information is reported on Form 477 does not guarantee confidential treatment of that information."[142] Carriers would have to demonstrate that their fiber and xDSL deployment data fall within the FCC's confidentiality rules whether reported on Form 477 or in ARMIS Report 43-07.[143]

AT&T also argues that shifting the reporting of fiber and xDSL deployment to Form 477 would impose new burdens on all other LECs that meet the Form 477 reporting threshold.[144] AT&T notes that only the largest ILECs are required to submit ARMIS 43-07 Reports, but all LECs that serve 10,000 or more voice-grade equivalent lines or 250 broadband lines would be subject to the new fiber and xDSL fiber requirements if those reporting requirements are shifted from ARMIS 43-07 Reports to Form 477.[145] AT&T asserts that the *Phase II Report and Order* concluded clear benefits to requiring the largest monopoly ILECs to report data relating to fiber and xDSL investment, but no such showing has been made that imposing requirements and costs

---

139 *Phase II Further Notice* at para. 211.

140 *Joint Petition for Reconsideration* at 10.

141 *See*, Joint Comments of BellSouth, SBC, Verizon, Qwest, Frontier, and CBT, filed in response to the *Phase II Further Notice* at 11.

142 *AT&T Opposition* at 10.

143 *Id*.

144 *See, AT&T Opposition*.

145 *Id*. at 11.

to the broader universe of LECs would produce any measurable benefit.[146] While requiring a larger universe of carriers to report fiber and DSL deployment would have significant benefits, especially in an environment in which the ILECs are seeking major regulatory reforms based on claims about their fiber and DSL deployment incentives and activities, AT&T argues that requiring this information to be produced through Form 477 would impose unnecessary costs upon competitive LECs.[147]

In summary, the carriers argue that the fiber and xDSL deployment data should be reported in Form 477 because it is confidential and proprietary information and will avoid duplicative and potentially inconsistent reporting requirements. The reporting of data in ARMIS reports does not preclude carriers from seeking confidential treatment of the data. On the other hand, the reporting of data in Form 477 does not automatically guarantee that the data will be held confidential. Whether reported in ARMIS Report 43-07 or Form 477, carriers will be required to show that fiber and xDSL deployment data fall within the FCC's confidentiality rules. For this reason, the Commission should deny the *Joint Petition for Reconsideration* and require the reporting of broadband infrastructure data in ARMIS Report 43-07 as set forth in the *Phase II Report and Order*. Nonetheless, the reporting of broadband infrastructure data should continue to be evaluated as to whether the data collection should be expanded to a larger universe of carriers.

C. Dominant Vs. Non-Dominant Carriers

Issue: Should the FCC agree with the "Dominant vs. Non-Dominant" argument of SBC in its Petition for Reconsideration?

Recommendation: No. SBC proposed that only dominant ILECs be subject to the Commission's accounting regulation. Approval of the limited definition of an ILEC, as proposed by SBC, would provide incumbent LECs with an inappropriate opportunity to avoid the statutory and regulatory obligations of ILECs by transferring a discrete service to a successor or assignee, and should be denied.

In its separate Petition for Reconsideration, SBC Communications Inc. asked the FCC to clarify that the amendment adopted to rule 32.11 of its accounting and reporting rules apply only to ILECs, as narrowly defined in 47 U.S.C. sections 251(h)(1)(A) or 251(h)(2)(B)(i), rather than to all ILECS as generally defined in section 251(h).[148] SBC argues that the fact that a carrier meets the general definition in section 251(h) does not consider whether the carrier is "dominant" in the markets in which it operates.[149]

---

[146] *Id*.

[147] *Id*. at 3.

[148] *See, SBC Reconsideration*.

[149] *Id*. at 2.

Section 251(h) states:

(h) Definition of Incumbent Local Exchange Carrier---

(1) Definition. —For purposes of this section, the term "incumbent local exchange carrier" means, with respect to an area, the local exchange carrier that---

(A) on the date of enactment of the Telecommunications Act of 1996, provided telephone exchange service in such area; and

(B)(i) on such date of enactment, was deemed to be a member of the exchange carrier association pursuant to section 69.601(b) of the Commission's regulations (47 C.F.R. 69.601(b);[150] or

(ii) is a person or entity that, on or after such date of enactment, became a successor or assign of a member described in clause (i).

(2) Treatment of Comparable Carriers as Incumbents.---The Commission may, by rule, provide for the treatment of a local exchange carrier (or class or category thereof) as an incumbent local exchange carrier for purposes of this section if---

(A) such carrier occupies a position in the market for telephone exchange service within an area that is comparable to the position occupied by a carrier described in paragraph (1);

(B) such carrier has substantially replaced an incumbent local exchange carrier described in paragraph (1); and

(C) such treatment is consistent with the public interest, convenience, and necessity and the purposes of this section.

SBC argues that section 32.11, which describes how companies will be classified for purposes of reporting, should apply only to those ILECS that are dominant in their markets, and that incumbency should be the basis for determining dominance for this purpose. The basis for this argument stems from a line of dicta in the FCC's *Phase II Report and Order* indicating that the accounting rules were currently applied only to incumbent LECs, "because they are the dominant carriers in their markets."[151] This appears to be a late-filed initial comment on the part of SBC. The *Phase II Notice*, at paragraph 44, specifically asked for comment on, "whether section 32.11 should be amended so that its requirements explicitly pertain only to incumbent LECs, as defined in section 251(h) of the Communications Act, and any other companies that the Commission designates by order." The FCC's *Phase II Report and Order* indicates that no comments were filed related to this proposal.

In support of its proposal SBC provides an example from the *Non-Accounting Safeguards Order* where the Commission held that a BOC could not avoid its network unbundling

[150] The highlighted sections are those portions of the ILEC definition, found at 47 U.S.C. § 251(h), that SBC asserts should be used to determine ILECs subject to the reporting requirements of rule 32.11.

[151] *Phase II Report and Order* at para. 126.

obligations by transferring a network element to a section 272 affiliate, noting that the section 272 affiliate would be deemed an ILEC under section 251(h) as a successor or assign of the BOC. However, this argument seems to confirm the wisdom of the FCC's action in using the broad, more general definition.

Approval of the limited definition of an ILEC, as proposed by SBC, would provide incumbent LECs with an inappropriate opportunity to avoid the statutory and regulatory obligations of ILECs by transferring discrete service to a success or assign, and should be denied.

APPENDIX A

Members of the Federal-State Joint Conference on Accounting Issues

The Honorable Kevin J. Martin, FCC Commissioner, Chair of Joint Conference

The Honorable Michael J. Copps, FCC Commissioner

The Honorable Diane Munns, Chair, Iowa Utilities Board, State Chair of Joint Conference

The Honorable Nancy Brockway, Commissioner, New Hampshire Public Utilities Commission

The Honorable Terry Deason, Commissioner, Florida Public Service Commission

The Honorable Rebecca A. Klein, Chairman, Texas Public Utility Commission

The Honorable Loretta Lynch, Commissioner, California Public Utilities Commission

Staff Members of the Federal-State Joint Conference on Accounting Issues

Tony Dale, Interim Legal Advisor to Commissioner Martin, FCC

Jane Jackson, Associate Bureau Chief, Wireline Competition Bureau, FCC

Clifford Rand, Deputy Division Chief, Pricing Policy Division, Wireline Competition Bureau, FCC

Jessica Rosenworcel, Legal Advisor to Commissioner Copps, FCC

Jason Williams, Special Assistant to Commissioner Martin, FCC

Emily Williford, Special Assistant to Commissioner Martin, FCC

James Bradford Ramsay, General Counsel, Supervisor/Director - NARUC Policy Department, National Association of Regulatory Utility Commissioners

Penny Baker, Assistant General Counsel, Iowa Utilities Board

Joseph Buckley, Utility Specialist 3, Ohio Public Utility Commission

Donna Nelson Geiger, Advisor to Chairman Klein, Texas Public Utility Commission

Chris Harris, Sr. Telecommunications Specialist, Division of Communications, Virginia State

Corporation Commission

Dianna Hathhorn, Accountant, Financial Analysis Division, Illinois Commerce Commission

Cayce Hinton, Assistant to Commissioner Deason, Florida Public Service Commission

Rich Kania, Director of Finance, Maine Public Utilities Commission

Pat Lee, Sr. Analyst, PSC, Florida Public Service Commission

Tom Long, Advisor to Commissioner Lynch, California Public Utilities Commission

ChristiAne Mason, Assistant Director, Telecommunications Division, New Hampshire Public Utility Commission

Joe Wiedman, Legal Intern, California Public Utilities Commission

Separate Statement of Commissioner Kevin J. Martin

Re: Federal-State Joint Conference on Accounting Issues, WC Docket 02-269, Recommendation Concerning Suspended Items, Outstanding Petitions for Reconsiderations, and Proposed Modifications to the Part 32 Accounting Rules

Today, the Federal-State Joint Conference on Accounting submits a series of recommendations to the Commission and requests that the Commission ultimately modify its accounting rules. I would like to commend my state and Federal colleagues for their commitment to resolving regulatory accounting issues and to thank them for their hard work in developing these recommendations. Telecommunications accounting issues are difficult and complex. My colleagues on the Joint Conference brought a wealth of experience and a thoughtful approach to dealing with these issues, and I believe the Commission and the public have benefited tremendously from their contributions and hard work. The recommendations of the Federal-State Joint Conference provide a critical starting point for evaluating needed changes to the Commission's accounting rules.

I write separately, however, to note that I continue to have some concerns about a few aspects of the recommendations of the Joint Conference. I agree that these critical issues should be addressed, but am not as sure that the information available at this time indicates that the benefits outweigh the costs.

I have some concerns about the recommendations pertaining to separate affiliates. For example, the Joint Conference recommends that, after the statutory sunset of the section 272 separate affiliate requirements, Bell Operating Companies (BOCs) should be required to maintain their in-region interLATA telecommunications service operations in a separate affiliate (with related accounting treatment). The Commission allowed the section 272 separate affiliate requirements to sunset in New York and Texas.[1]

The Joint Conference also recommends extending the affiliate transactions rules to apply to transactions between two regulated incumbent local exchange carriers (LECs). The Commission has never applied the affiliate transactions rules to these types of transactions.[2] Several state commissions have raised valid concerns about the risk of anticompetitive conduct for these types of transactions. Based on the information available to the Joint Conference at this time,

---

[1] *See* Public Notice, *Section 272 Sunsets For Verizon in New York State By Operation of Law on December 23, 2002 Pursuant to Section 272(f)(1),* 17 FCC 26864 (2002); Public Notice, *Section 272 Sunsets For SBC in the State of Texas By Operation of Law on June 30, 2003 Pursuant to Section 272(f)(1),* 18 FCC Rcd 13566 (2003); *see also Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements,* Further Notice of Proposed Rulemaking, 18 FCC Rcd 10914 (2003).

[2] *See Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, 11 FCC Rcd 17539, para. 107 (1996) (*Accounting Safeguards Order*) (subsequent history omitted).

however, it is not clear to me that the benefits of extending the affiliate transactions rules into this area outweigh the costs.[3]

Despite these concerns, I believe it is extremely important that a forum be developed for notifying the Commission of accounting-related concerns and for identifying issues of concern to the states. In this regard, the Joint Conference on Accounting has been extremely successful at facilitating state commission input into the Commission's decision-making process for accounting issues and for renewing and beginning to formalize a dialogue on the broader issues related to accounting.

I support the Joint Conference recommendation for the Commission to initiate a Notice of Proposed Rulemaking seeking comment on the Joint Conference proposals. I look forward to continuing to work on these recommendations of the Joint Conference, and to receiving additional feedback from our state colleagues and others as we work to resolve these issues.

---

[3] Similarly, I have some concerns about the recommendation to eliminate the central services organization exemption to the affiliate transactions rules, which the Commission adopted as part of the post-1996 Act rulemaking on accounting issues. In the 1996 rulemaking, the Commission found that the central services organization exemption would benefit consumers by allowing incumbent LECs to take advantage of economies of scale and scope. *See Accounting Safeguards Order* at para. 148 (explaining the basis for the central services organization exemption). Based on the information available at this time, I question whether it is necessary to eliminate the exemption for central services organizations.

SEPARATE STATEMENT OF
COMMISSIONER MICHAEL J. COPPS

Re: *Federal-State Joint Conference on Accounting Issues* (WC Docket No. 02-269), Recommendation

One year ago, I expressed enthusiasm when the Joint Conference on Accounting was first convened. In light of the accounting depredations that have haunted the telecommunications industry and the economy as a whole, I believed then—and believe now—that review and attention from both state and federal authorities is absolutely essential.

Today, the Joint Conference offers a Recommendation that is a roadmap. It provides the Commission with a set of directions that address where and how it should head next in its accounting review. The Commission now must move swiftly to convert this Recommendation into a Notice of Proposed Rulemaking.

Through participation in this group, it has become clear to me that it is vitally important that the Commission ensure that the States have the accounting information they need to do their jobs. Both the States and the Commission use reported data to develop an understanding of the plant, revenue and expenses of carriers and to enable comparisons among companies and over time. States also use it to develop prices for network elements, develop prices for resold services and conduct ratemaking proceedings. In short, if the Commission's periodic streamlining efforts strip the States of the uniform accounting data they need, they will be unable to carry out their statutory responsibilities.

I regret that this fact was not as lucid to the Commission as it should have been when it embarked on the *Phase III Further Notice of Proposed Rulemaking*. At the time, the Commission suggested that we should only collect accounting information for which there is a federal purpose, notwithstanding any state need for the data. Yet we have entered an era when more information—not less—is necessary to ensure that consumers are confident and investors secure. We have a duty to ensure that the required system of accounts provides both state and federal regulators with the information they need to discharge their required tasks.

To this end, I am heartened by the approach taken in the Joint Conference Recommendation. The Recommendation specifically rejects the federal purpose standard and approaches its review under the broad charge of the Order convening the Joint Conference. This mandate directs the Joint Conference to evaluate accounting requirements that both state and federal regulators need and to further the development of improved regulatory accounting and related requirements. I believe the approach taken in the Recommendation is the right way to go and the right thing to do.

Although the progress we make today is good news, there is *much more work to be done*. This Recommendation addresses only a narrow subset of the mandate. We have more fundamental challenges ahead as we work to live up to our charge to ensure that data filed by carriers are adequate, truthful and thorough.

I believe the Joint Conference should move next to assess broader issues that impact regulatory accounting and reporting reliability. I hope we can start by rigorously reviewing the scope of the authority granted to the Commission by Congress. In particular, I would like the Joint Conference to consider how use of the Commission's authority to inquire into the business management of carriers under Section 218 might have helped us to identify recent corporate governance problems ranging from capacity swaps to tactics to circumvent access charges. The Commission also has specific requirements that carriers must comply with concerning continuing property records. I hope we can take a hard look at how the Commission can undertake regular continuing property record audits to ensure that carriers maintain equipment in compliance with Commission rules and verify that property is recorded in proper accounts. Finally, I hope the Joint Conference can serve as a vehicle for jumpstarting discussion with other agencies at the state and federal level with interest in the soundness of regulatory accounting and reporting requirements. Such discussion could help inform the recommendations of the Joint Conference to the Commission.

I commend my state and federal colleagues on the Joint Conference for their extraordinary effort. I commend them for their commitment to thinking through the thorny issues of our accounts, subaccounts, separate affiliate rules and reporting requirements. This group tackled issues as complex as they come. They are devoted to ensuring we craft an accounting regime that will best serve the public interest. We all benefit from their contributions and hard work. I also wish to commend the leadership of our Chairman, FCC Commissioner Martin. Commissioner Martin has encouraged the Joint Conference to act expeditiously on the specific accounting rules before us and also to look more broadly at what needs to be done so that our accounting rules are up to the needs and the high standards of corporate governance that the American people have a right to expect in light of events over the past few years.