

Cross Telephone Company, L.L.C.

Audit Appeal to FCC

Exhibit 2

USAC Appeal Decision

***Administrator's Decision on High Cost Program Appeal***

*Via Email and Certified Mail*

July 2, 2019

Denise N. Smith  
Kelley Drye & Warren LLP  
Washington Harbour, Suite 400  
3050 K Street NW  
Washington, D.C. 20007-5108

Re: Request for Review of Decision of the Universal Service Administrator High Cost Audit  
of Cross Telephone Company – SAC No. 431985; Audit Report HC2016BE031

Dear Ms. Smith:

The Universal Service Administrative Company (USAC) has completed its review of an appeal filed by Cross Telephone Company (Cross Telephone or Cross).<sup>1</sup> USAC engaged an outside firm, Moss-Adams LLP (Moss Adams), to conduct an audit of Cross Telephone's compliance with the Federal Communications Commission's (FCC) rules for the High Cost Support Program, which resulted in eight findings.<sup>2</sup> Based on the audit, USAC issued a letter recommending recovery in the amount of \$8,251,829 related to Finding 1: incorrect treatment of rent expense paid to an affiliate.<sup>3</sup> On January 4, 2019, Cross Telephone filed an appeal related to Finding 1, requesting that USAC reverse Finding 1.<sup>4</sup>

USAC has completed its review of the Appeal, including the supporting documentation, FCC rules, as well as facts related to this matter and has determined that FCC rules do not support reversal of Finding 1. Therefore, as discussed in detail below, USAC denies the Appeal.

**Background**

***The Audit.*** At USAC's request, Moss Adams performed audit procedures to assess, among other things, the reasonableness of Cross Telephone's affiliate transactions, including the provision of

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<sup>1</sup> Letter from Denise N. Smith, Kelley Drye & Warren LLP to USAC (Jan. 4, 2019) (Appeal), *see also* Letter from Denise N. Smith, Kelley Drye & Warren LLP to USAC (Jan. 7, 2019 Letter).

<sup>2</sup> *See* Audit of Cross Telephone Company, Compliance with High Cost Audit No. HC2016BE031 (SAC 431985), conducted by Moss Adams LLP on behalf of USAC (Performance Audit on Compliance with Federal Universal Services Fund High Cost Support Mechanism Rules) (Oct. 4, 2018) (Audit Report).

<sup>3</sup> *See* Letter from USAC to R. David Wright (Nov. 9, 2018) (stating that USAC would recover \$8,286,794 as result of the audit). Note: in the Audit Report, Moss Adams determined that the net monetary effect of Finding 1 totaled \$8,251,829. *See* Audit Report at 5.

<sup>4</sup> *See* Appeal.

services between Cross Telephone, an incumbent local exchange carrier (ILEC) and its affiliate, MBO Video LLC (MBO).<sup>5</sup>

With respect to Finding 1, Moss Adams determined that Cross Telephone: (1) did not comply with the High Cost Program's procedures for separating telecommunications expenses; (2) did not have sufficient processes to prepare, review, and approve its cost studies; and (3) did not identify certain affiliate transactions as substantial rents in its filings, as required under section 36.2(c)(2) of the FCC's rules. Specifically, Moss Adams determined that (1) in Reporting Years 2010, 2011, 2012, 2013, and 2014 Cross Telephone incorrectly included amounts in its cost studies and HCP filings for the relevant filing years "in account 6230, circuit expense for substantial rent expense paid to an affiliate for the use of interexchange plant assets owned by its affiliate," and (2) Cross Telephone "should have removed the circuit expense and needed to include the rented interexchange plant and related expenses in its HCP filings in accordance with FCC rules."<sup>6</sup>

During the audit, Cross Telephone stated that, "the transaction does not involve the 'use of interexchange plant assets' owned by an affiliate through a lease agreement" and it "purchases transport services provided by the DS1 circuits owned and operated by its affiliate, MBO Video, and has no right to access, use, or integrate MBO Video's facilities through a lease arrangement."<sup>7</sup> Cross Telephone also asserted that a 2009 audit performed by KPMG LLP (KPMG) on behalf of USAC included a review of the transaction in question and auditors found no error in Cross Telephone's expense reporting methodology in relation to the DS1 transport service purchase and that the services in question for Finding one are identical to the DS1 transport services reviewed in the current audit.<sup>8</sup> Cross Telephone further explains that the service arrangement "did not involve the sale of assets to an affiliate and the subsequent lease-back of those assets."<sup>9</sup> Cross Telephone requested that, if the auditor's finding is upheld, then the guidance is applied on a prospective-only basis.

Moss Adams determined that section 36.2(c) of the FCC's rules and the *Moultrie Order*<sup>10</sup> were applicable because a substantial rent expense was assigned to jurisdiction and Part 69 access elements, which are largely loop or subscriber plant in nature, but there was no associated interexchange plant included in Cross Telephone's cost studies.<sup>11</sup> After consideration of the facts and data supporting the above arguments, Moss Adams determined that in Disbursement Years 2012, 2013, 2014, 2015, and 2016, Cross Telephone received overpayments totaling \$8,251,829 related to incorrect treatment of substantial rent paid to an affiliate.<sup>12</sup>

*The Appeal.* In its Appeal, Cross Telephone makes the following four arguments:

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<sup>5</sup> Audit Report at 6.

<sup>6</sup> *Id.* at 12.

<sup>7</sup> *Id.* at 15 and Attachment 1 (MBO Master Service Agreement).

<sup>8</sup> *Id.* at 18-19.

<sup>9</sup> *Id.* at 20.

<sup>10</sup> *Moultrie Independent Telephone Company, Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Order, 16 FCC Rcd 18242, 18245, para. 6 (2001) (*Moultrie Order*).

<sup>11</sup> Audit Report at 23.

<sup>12</sup> *Id.* at 23-4.

- (1) Its purchase of DS1 transport service from MBO is not a property sale and lease-back affiliate transaction under FCC rule 36.2(c)(2) and therefore is dissimilar to the issue in the *Moultrie Order*;<sup>13</sup>
  - (2) FCC Rule 36.2(c)(2) applies only to affiliate *property* sale and lease-back transactions, as opposed to the purchase of *services*;
  - (3) Application of the *Moultrie* decision and section 36.2(c)(2) of the FCC rules to affiliate service purchases requires unreasonably broad interpretation of the rule, going beyond the authority of USAC and its external auditors; and
  - (4) It relied on USAC's prior awareness and silence regarding its affiliate service purchase reporting methodology via a 2009 KPMG audit, and any new guidance related to affiliate reporting should be applied prospectively, not retroactively.<sup>14</sup>
- Cross Telephone therefore requests that USAC reverse Finding 1.<sup>15</sup>

## **Discussion**

USAC denies the Appeal because the FCC rules and facts related to this matter do not support overturning Finding 1.

Rate-of-return carriers follow a multi-step process under FCC rules and precedents to identify the costs permissible for recovery through federal universal service support.<sup>16</sup> As a first step in the regulatory cost accounting process, the companies record their costs, including investments and expenses, into various accounts in accordance with the Uniform System of Accounts (USOA), Part 32 of the FCC rules.<sup>17</sup> The second step in the regulatory cost accounting process requires rate-of-return companies to directly assign or allocate investments, expenses, and revenues between regulated and nonregulated activities using the rules contained in Part 64.<sup>18</sup> The third step in the regulatory cost accounting process for high-cost support is that rate-of-return companies separate their regulated investments, expenses and revenues between the intrastate and interstate jurisdictions in accordance with Part 36 (Jurisdictional Separations), which contains procedures and standards for dividing telephone company investment, expenses, taxes, and reserves between the state and the federal jurisdictions.<sup>19</sup>

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<sup>13</sup> In the *Moultrie Order*, with respect to part 36(c), the FCC stated, “[w]hen a *substantial amount of investment is involved*, the jurisdictional allocation of the lease payment and the combined separations results would be skewed . . . if the assets were not included in the appropriate separations categories and jurisdictionally allocated based on the rules for the investment-type involved.”

<sup>14</sup> See Appeal.

<sup>15</sup> *Id.*

<sup>16</sup> See generally 47 CFR pts. 32, 36, 54, 64, 65, and 69.

<sup>17</sup> The USOA sets forth a standard chart of accounts and directs companies how to record certain transactions in their books of account and establishes rules for a carrier's affiliate transactions.

<sup>18</sup> 47 CFR §§ 64.901–04. Specifically, when a carrier subject to the Act uses the same facilities to provide both telephony service and a nonregulated service such as video, the carrier must allocate the costs of such facilities between these services. See also 47 C.F.R. § 32.14(a) (providing that “regulated accounts shall be interpreted to include the investments, revenues and expenses associated with those telecommunications products and services to which the tariff filing requirements contained in Title II of the Communications Act of 1934 . . . are applied . . .”) and 47 CFR § 32.23 (describing nonregulated activities).

<sup>19</sup> See 47 CFR Part 36. The separations procedures set forth in Part 36 are designed primarily for the allocation of property costs, revenues, expenses, taxes and reserves between state and interstate jurisdictions. 47 CFR § 36.1(b).

In years 2010-2014, Cross Telephone reported more than \$11.5 million as circuit expense in account 6230 (plant specific operations expense - central office transmission expense). During the audit, consistent with the first step in regulatory accounting, Moss Adams reviewed supporting documentation related to Cross Telephone's cost. Moss Adams correctly noted that in the industry, parties may label transactions as either lease or rents despite the fact that the underlying documentation supporting the transactions may suggest otherwise.<sup>20</sup> In this case, in Cross Telephone's 2013 its Audit Financial Statement, Cross reported the relevant costs as lease expense, and in its cost studies, reported the transaction under the rents portion of circuit expense.<sup>21</sup> Based on the carrier-provided documentation, Moss Adams determined that the transaction involved interexchange transport activities.<sup>22</sup>

We do not find persuasive Cross Telephone's argument that the transaction with MBO Video does not involve the use of interexchange plant assets owned by an affiliate, but relates to the purchase of services provided by the DSI circuits owned and operated by an affiliate. With its affiliates, a regulated entity, such as Cross Telephone, may draft its arrangements with any terms and provisions it desires. The FCC has previously recognized that companies may attempt to maximize federal high-cost support through transactions with an affiliate. Additionally, the fact that Cross Telephone paid less for the circuit lease with its agreement with MBO Video than it did in an agreement with a non-affiliated company is irrelevant. Cross Telephone is obligated under FCC rules to accurately report its costs. We agree with Moss Adams that the transaction involved costs related to the provision of interexchange service, and thus, agree that Cross improperly reported the costs in account 6230.

In the Audit Report, Moss Adams stated:

We recognize the transaction in Finding #1 *is not necessarily a sale and lease-back of interexchange plant*. However, *we believe the same principles discussed in the Moultrie Order apply to the Beneficiary*. The Beneficiary incurred substantial interexchange expenses, and without associated or representative interexchange plant included in its cost studies, the interexchange expenses were improperly assigned to jurisdictions and Part 69 access elements based on the Beneficiary's existing plant categories, which is largely loop or subscriber plant in nature. We believe this results in grossly overstated loop costs recovered from HCLS and ICLS and grossly understates interexchange costs recovered from LSS and CAF.<sup>23</sup>

We agree that Part 36.2(c), as discussed in the *Moultrie Order*, is applicable. As stated in the *Moultrie Order*, Part 36.2(c), "directs incumbent carriers on the proper treatment of property rented to or from affiliates and *related costs* (i.e., reserves, revenues, expenses, lease payments) in the performance of a Part 36 cost study."<sup>24</sup> The rule, in relevant part, provides that, if the property involved in the transaction *is* substantial in amount, the carrier performing the cost study must include the investment, accumulated depreciation, and associated expenses in, and

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The jurisdictional separations process begins with the Uniform System of Accounts, Part 32 of the Commission's rules. See 47 CFR § 36.2(f).

<sup>20</sup> Audit Report at 22.

<sup>21</sup> *Id.*

<sup>22</sup> Cross had allocated the interexchange costs to exchange categories and sought high cost support for the costs.

<sup>23</sup> Audit Report at 23.

<sup>24</sup> *Moultrie Order*, 16 FCC Rcd 18247, at para.10 (*emphasis added*).

exclude the lease payments from, the carrier's telephone operations for purposes of the Part 36 cost study. In this case, the lease of the circuits from an affiliate is substantial in amount (more than \$11.5 million in the period from 2010 to 2014), thus section 36.2(c) is applicable.

In its Appeal, Cross stated that it “purchased DS1 transport *services*, not DS1 facilities from” from MBO Video.<sup>25</sup> The distinction is irrelevant as section 36.2(c) is applicable to the lease of property or the lease of a service, when lease is between the regulated entity and its affiliate and is substantial in amount.<sup>26</sup> As the FCC stated in the *Moultrie Order*, “Carriers are free to sell plant to, or lease plant and equipment from, affiliates or non-affiliates. They are not free, however, to ignore the Commission's rules and safeguards designed to prevent abuse of affiliate transactions by incumbent LECs.”<sup>27</sup>

Finally, USAC must audit regulated entities consistent with all applicable FCC rules and lacks the authority to apply Part 36.2(c) prospectively, as requested by Cross Telephone.

### **Conclusion**

For the reasons stated above, USAC denies the Appeal and will recover \$8,286,794 in relation to the Findings in the Audit.

If you wish to appeal this decision with the Commission or request a waiver, follow the instructions pursuant to 47 C.F.R. Part 54, Subpart I (47 C.F.R. §§ 54.719-.725); you may find additional instructions for filing appeals or requesting waivers at:

<http://www.usac.org/about/about/program-integrity/appeals.aspx>

Sincerely,

//s// Universal Service Administrative Company

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<sup>25</sup> Audit Report at 16.

<sup>26</sup> *Moultrie Order*, 16 FCC Rcd 18247, at para.10.

<sup>27</sup> *Id at.* 18249, at para.15.