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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
Simplification Of The)
Depreciation Prescription Process) CC Docket No. 92-296

REPLY COMMENTS OF THE
NYNEX TELEPHONE COMPANIES

New York Telephone Company
and
New England Telephone and
Telegraph Company

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Summary Of NYNEX Telephone Companies' Reply Comments In
CC Docket No. 92-296

The record supports adoption of the FCC's price cap carrier proposal. It will best achieve the Commission's objective to simplify and modernize the depreciation process in line with the rapidly changing competitive and technological environments in which we operate. It will also provide for reasonable flexibility, timeliness, predictability and consistency with respect to capital recovery.

We refute the contentions of those parties who question the FCC's price cap carrier option. Among other things, that option:

- comports with the Commission's price cap mechanism;
- will not contribute to any "manipulation" of depreciation expense, given the realistic incentives of carriers and the ample monitoring and safeguards that apply;
- is particularly justified in light of accelerating competition and the need to facilitate the modernization process;
- is fully consistent with the FCC's responsibilities to prescribe depreciation and notify the states; and
- is superior to the other options put forth by the Commission; those options will not provide for substantial simplification nor enable timely and effective capital recovery.

Finally, we show there is no basis for changing the current treatment of salvage in the depreciation process.

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REPLY COMMENTS OF THE
NYNEX TELEPHONE COMPANIES

I. INTRODUCTION

New England Telephone and Telegraph Company and New York Telephone Company (the NYNEX Telephone Companies or NTCs) submit these Reply Comments to parties' comments filed March 10, 1993, in the above-captioned matter. These pleadings were invited by the Commission's Notice Of Proposed Rulemaking

II. THE PRICE CAP CARRIER PROPOSAL SHOULD BE ADOPTED

We showed in our initial Comments² that the price cap carrier proposal³ will best meet the FCC's objectives by significantly reducing and simplifying the paperwork that underlies the depreciation prescription process. That proposal will also afford Telephone Companies the flexibility to respond to growing competition and market forces in a timely manner, and provide for a predictable and consistent recovery of investments. The price cap carrier option is most consistent with Commission policy and objectives favoring competition and infrastructure development. Further, that option is fully consistent with the FCC's responsibilities to prescribe depreciation and notify the states.⁴

A. Price Cap Mechanism

AT&T claims (pp. 8-10) that under the price cap mechanism, LECs may "manipulate" depreciation rates to avoid sharing or obtain a low end adjustment.⁵ This speculation

² See also Ameritech, Bell Atlantic, BellSouth, Cincinnati Bell, GTE, Pacific Bell, SNET, Southwestern Bell, USTA, United Tel. -- Southeast, U S West.

³ Under this option as written, price cap carriers would file proposed depreciation rates without supporting data, and the Commission would prescribe depreciation after conducting a notice and comment proceeding. See NPRM para. 12.

⁴ See Section 220(b), (i) of the Communications Act, 47 U.S.C. Section 220(b), (i).

⁵ See also California Cable Television Association (CCTA), Colorado PUC, GSA, MCI, NARUC.

misses the mark. As shown in our initial Comments (pp. 8-10), depreciation accounting must conform to generally accepted accounting principles, and to FCC and SEC requirements, as well as withstand audits and regulators' scrutiny.⁶ LEC-proposed depreciation rates will continue to be subjected to a pleading cycle and public scrutiny -- including comments by competent, sophisticated intervenors -- and will be subject to final approval or disapproval of the Commission.⁷

5 (Footnote Continued From Previous Page)

MCI wrongly states (n. 3) that the NTCs, in a 1992 low end adjustment which reflected workforce downsizing, manipulated the interplay between the sharing mechanism and earnings results. Curiously, MCI then cites its own prior pleading as support, but fails to mention that the FCC (Chief, Common Carrier Bureau) subsequently released an Order explicitly rejecting MCI's position on this point. CC Docket No. 92-141, 1992 Annual Access Tariff Filings, Order released June 22, 1992, paras. 9-13. In this difficult economy, the NTCs were hardly alone in taking a one-time charge for downsizing in 1992, which properly increased our operating expense for that year. The FCC's low end adjustment was specifically designed to provide a mechanism to prevent unreasonably low earnings in such a recessionary circumstance. See CC Docket No. 87-313, LEC Price Cap Order released October 4, 1990, 5 FCC Rcd 7664, paras. 144-50.

6 See also BellSouth, SNET, USTA.

7 The Commission has many ways to monitor depreciation practices of LECs and to correct for any it finds to be adverse to the ratepayers' interest. BellSouth (pp. 28-29) and USTA (pp. 23, 26-27) specify some of the reports detailing depreciation expense, which reports the FCC continues to require.

The FCC possesses substantial regulatory powers over depreciation. See, e.g., 47 U.S.C. Section 220(b) (FCC "shall" prescribe depreciation, and may change rates); 220(c) (FCC access to information); 4(i) (FCC power to issue orders, not inconsistent with the Act, to execute its functions); 4(j) (FCC power to conduct proceedings); 213 (FCC power to inquire into management of business);

(Footnote Continued On Next Page)

In no event will depreciation rates yield more than 100% recovery of capital investments.⁸ It is also unrealistic to think a LEC would purposely reduce reported earnings to shareholders and unnecessarily reduce the rate base.

In any case, our initial Comments (p. 13) offered additional guidelines which would alleviate any remaining concern on potential manipulation. For example, we suggested that depreciation rates be prospectively set. Once set, depreciation rates could not be changed to adjust for unexpected revenue or expense variations. It would be highly risky to set inappropriately high depreciation rates at the beginning of a year, betting that characteristically volatile earnings would be so high as to cover those expenses. Obviously, if the revenues failed to materialize, this action could turn what would have been a good year into a mediocre year, or possibly an acceptable year into a disaster. Attempts to set depreciation rates to force upward adjustments would be even more risky. It is unrealistic that corporations would deliberately set out to force a poor financial year. Even worse, if revenues did prove to be higher than anticipated, what could have been a reasonably profitable year (without the

⁷ (Footnote Continued From Previous Page)

219 (Reports by carriers; carriers to provide specific answers to all FCC questions); 403 (Inquiry by FCC on own motion); 47 C.F.R. Sections 1.1 (FCC can always start proceedings and gather information); 0.91(g) (Common Carrier Bureau can obtain from carriers full and complete information to enable FCC to perform its duties).

⁸ See USTA.

depreciation change) would turn out to be marginal, not high enough to impress investors and not low enough to merit a price cap adjustment.

AT&T further notes (p. 7) that during its first three and one-half years of price cap regulation, its rates declined by at least \$1.5 billion, while AT&T was granted over \$2 billion in increased depreciation during that same period. AT&T claims the highly competitive nature of the interexchange telecommunications marketplace determines the level of its rates.⁹ AT&T's statistics on the lack of linkage between its rates and its depreciation expense fail to acknowledge a few other limits on its rates. Just as depreciation is an endogenous cost under LEC price cap regulation, so too is it an endogenous change under AT&T price cap regulation. AT&T was not permitted to pass along the depreciation expense increases in the form of higher rates for service. Moreover, from 1989 through 1992, the access charges paid by AT&T to the LECs decreased by \$1.988 billion, reductions that AT&T was obliged to pass along to ratepayers.¹⁰

Finally, of course, AT&T was not reporting those increased regulatory depreciation expenses in its financial reports to shareowners because it had already taken the charge to earnings on its financial reports in 1983, and again in 1988. In effect, the increased regulatory depreciation expense

⁹ The competitive nature of the NTCs' markets is addressed infra.

¹⁰ See Peter Huber, The Geodesic Network II, p. 3.36.

merely served to hold down AT&T's reported regulated earnings to more defensible levels.

MCI echoes AT&T's argument that the price cap sharing mechanism provides the LECs an incentive to manipulate depreciation expense under the price cap carrier option.¹¹ In its Attachment 1, MCI purports to demonstrate the sensitivity of rate of return to depreciation changes. But MCI offers misleading semantics in its analysis of the effect of a 1% change in depreciation expense; MCI claims that a 1% change in depreciation expense yields a 1.3% change in rate of return.¹² MCI actually uses a change of 1% of the gross plant, or \$79,361.¹³ This \$79,361 is actually 12.6% of the depreciation expense of \$629,127 used in the calculation. A change of 12.7% in depreciation expense is hardly minor.¹⁴ Our calculations based on the 1991 Form M Reports for the NTCs are attached. We show that a true 1% change in depreciation expense would cause a .08% (eight one hundredths of a percent) change in the rate of return.

MCI further suggests (9-10) that depreciation simplification should not take place until after the first price cap review period for LECs, and that simplification

11 MCI pp. 5-7.

12 MCI p. 7.

13 We assume MCI intends for dollars to be shown in thousands.

14 MCI also fails to adjust the net plant for the increase in depreciation expense. The increase in depreciation expense would reduce net plant, and thereby increase the rate of return.

should result in an increase in the productivity factor. MCI's position is contrary to the purpose of price caps.¹⁵

Carriers should be encouraged, not discouraged, to be more efficient and save costs, and should be rewarded for efficiency above the productivity factor. MCI has shown no convincing reason to delay the benefits to be gained from depreciation simplification.

In a different vein from AT&T's and MCI's above manipulation argument, the New York State Department of Public Service (NY DPS) expresses a concern (p. 3) that Telephone Companies would manipulate depreciation expenses to increase short term earnings and increase an already significant reserve deficiency. In this connection, the NY DPS cites (p. 4) New York Telephone's (NYT's) request in 1992 to amortize sharply increased outside plant depreciation expense. However, that request by NYT points up the need for depreciation simplification. NYT appropriately tried to mitigate the depreciation expense impact of recovering the last 50% of interoffice metallic cable investment in the last 4 years of a service life exceeding 20 years. Some depreciation flexibility in the past might have prevented this depreciation mismatch. In comparable instances, the NY DPS has favored amortization to avoid ratepayer shock.

¹⁵ The productivity factor is already based on historical data plus an increased level (.5%) to reflect consumer benefit.

B. Competition/Modernization

Predictably, AT&T portrays itself as facing pervasive competition which warrants adopting the price cap carrier option for itself but not for LECs.¹⁶ In anticipation of this argument, the NTCs' initial Comments (pp. 14-18) detailed the intensifying competitive environment we face (e.g., collocation and numerous competitive entry dockets). There simply is not a difference in circumstances between AT&T and the price cap LECs that warrants disparate treatment in depreciation simplification.¹⁷

The NY DPS contends (p. 3) that competition is not yet far enough advanced to implement depreciation simplification. The NY DPS's position is very puzzling, as the DPS has been on the leading edge of fostering competition in LEC markets.¹⁸ For example, a former Deputy Chairman of the NY PSC remarked:

Consumers will not see the benefits of competition unless all providers of competitive services are free to compete on product, price, and quality. This means removing onerous regulation from the telcos. It means,

not be raised again within a specified time frame (to prevent predatory pricing).¹⁹

MCI posits (p. 1) "the fundamental issue of who should fund the plant whose obsolescence is accelerated by the increasing desire of the LECs to enter competitive markets." This is a bogus issue. The LECs' entry into competitive markets is hardly as described by MCI. It is more a case of the LECs' formerly single-provider markets becoming competitive, both through technological evolution and regulatory initiatives. The competitors in those markets opened by regulatory initiatives offer new technology to replace the basic services provided by the older technology, along with offering expanded service packages growing out of the new technology. Subscribers who opt for these expanded service packages do so as a replacement for the NTC services now offered, not as an addition to the old services. To satisfy customers' desires for the functionality made possible by these new technologies and for the expanded service packages, the LECs have little choice but to compete by deploying such technologies in order to stay in the telecommunications business.

MCI also refers to "accelerated depreciation" of LEC plant, and indicates the shareholder should fund modernization.²⁰ However, to our knowledge, none of the LECs

¹⁹ Gail Garfield Schwartz, Deputy Chairman, NY PSC, 1992, as quoted in Tomorrow's Information Highways, A Report Of The New York State Telephone Association Infrastructure Task Force, 1992.

²⁰ MCI p. 2.

has brought up accelerated depreciation, a method not allowed under FCC rules.²¹

The specific objection raised by MCI (p. 2 n. 1), that MCI should not pay for fiber in the loop as opposed to fiber to the interexchange carriers (IXCs), is not valid. In the first place, MCI is paying for neither; the shareholders paid and are paying for both. MCI pays for LEC interstate services now under price cap regulation. Next, the fiber in the loop is cost effective. At this point it is primarily used to connect field subscriber line carrier equipment to the central office. It is cheaper to serve subscribers in this manner than run new copper cable, and MCI stands to benefit from the cost-saving technology.

More generally, competition aside, the LECs modernize to improve service, and to reduce capital costs and investment-related expenses such as maintenance.²² This

²¹ See 47 C.F.R. Section 32.2000(g)(2)(ii).

²² Everyone benefits from a modern telecommunications network infrastructure. We have completed our replacement of electromechanical switching equipment and are now replacing the analog ESS switches with digital switching equipment. The replacement of metallic interoffice cable with fiber is almost complete. Fiber in the subscriber plant is now far enough along to be well-established as the replacement technology, not merely a niche application. The Telephone Companies do engage in continual modernization. While each stage does provide additional services and convenience, modernization largely proceeds based on improving the efficiency of the existing services. Digital switches are more reliable, provide better transmission and require fewer people to operate than the analog ESS switches they are replacing. Fiber, even in the subscriber loop, provides for better transmission and less maintenance, and costs less per circuit than metallic cable.

modernization is funded by investors through injection of new capital, retained earnings and reinvestment of capital recovered for the consumption of embedded plant in the provision of customer service. Customers do not pay for modernization, per se. They pay for services which use up plant.

That is, Telephone Company capital investment has been (and still is) funded through a combination of debentures, retained earnings, and revenues charged to depreciation expense. Debentures represent a financial market transaction, hardly forced upon ratepayers, and are ultimately paid off through retained earnings, depreciation, or both. Retained earnings are that portion of earnings which are reinvested, rather than being paid out as dividends.

Depreciation is the accounting mechanism used to permit the recovery of the cost of a capital asset over the useful life of that asset. On a cash flow basis, the full cost of a capital asset is paid, upon receipt, by the capital investors (the shareholders) of the corporation. From a cash flow perspective, depreciation is the mechanism to repay those investors. This is why the revenue collected and attributed to depreciation expense is referred to as capital recovery. It is the recoupment of the investors' capital.

In order for the corporation to remain an ongoing entity, the recovered capital is substantially reinvested in the business to maintain the value of the asset base. This reinvestment mechanism serves both the shareholders and the ratepayers. The shareholders benefit from maintaining the

value of the physical assets and the ratepayers benefit from a continuation and improvement of quality, efficient service. These continued cycles of reinvestment do not transfer the rights to those assets to the users of the service. The assets remain the property of the investors. Despite decades of cycles of depreciation, capital recovery and reinvestment, the shareholders are still the owners of General Motors, Kodak and the Telephone Companies, for example.

C. CCTA's "Net Additions" Argument

CCTA maintains (p. i) that depreciation simplification efforts cannot properly be related to furthering network investment. CCTA attaches the results of a study purporting to show that increased depreciation expense has not translated into increased investment in the telephone network. The fatal flaw of that study, however, is its use of net plant additions as a surrogate for telephone network investment.

According to CCTA, net plant additions do not track depreciation accruals. While not defined by CCTA, the net plant additions used in Table I of its Comments seem to be the changes in telephone plant in service (TPIS), year to year. The correlation between net plant additions and depreciation accruals does not exist because it should not exist.²³ One example of the fallacy of trying to make such a correlation can

²³ The net plant used in CCTA's Comments roughly measures gross additions less retirements. The presence of telephone plant under construction and accounting adjustments further affect net plant.

be shown in the motor vehicle account. In 1988, NYT moved to a motor vehicle leasing policy. Since then, gross additions have been zero and the account balance (TPIS) has steadily decreased. Net plant additions, as used by the CCTA, have been negative. We must continue to depreciate our older investment, at about \$14 million per year, until the account is completely recovered. There is a clear mismatch here between net plant additions and depreciation expenses. Capital recovery relates to gross plant. CCTA's comments in effect match apples to oranges and should be rejected.

D. Reserve Imbalance

The NY DPS contends (p. 10) that if any of the depreciation simplification options is adopted, the Telephone Companies should be responsible for any future depreciation reserve imbalances.²⁴ A reserve imbalance from past regulatory methods and policies does exist, as acknowledged by the NY DPS (p. 3). The NTCs agree that if the price cap carrier option is adopted, the NTCs would be responsible for future reserve imbalances created by depreciation rates proposed by the NTCs and adopted by the FCC and State commissions.²⁵ A greater degree of pricing flexibility becomes even more critical as the NTCs remain under varying

24 See also California PUC.

25 The Virginia State Corporation Commission Staff acknowledges (p. 3) that carriers may not properly be held responsible where "underrecovery occurs from being constrained by a prescribed range."

forms of rate regulation, and their ability to set prices to recover the capital associated with the depreciation reserve deficiency is constrained. The NTCs believe that the issue of the existing reserve deficiency is too complex to be resolved as a part of depreciation simplification; a further proceeding in this area is warranted.

E. Underlying Data

Some commentators object to the price cap carrier option because data supporting the filed depreciation rates would be absent. These parties also assert that under that option, the ability of the states to respond to and comment on proposed depreciation rates will be impaired.²⁶ In our initial Comments (pp. 10-13), we showed how the price cap carrier option is fully consistent with the FCC's depreciation responsibilities. Among other things, we have offered to submit essentially the same data supporting depreciation rates under the price cap carrier option as has been suggested for the basic factors range option. The addition of a brief narrative supporting the rates under the price cap carrier option is more than would be available under the basic factors range option.

A three-way, face to face meeting may be useful to some of the states, but is technically not required as a form of notice under Section 220(i) of the Communications Act.

²⁶ E.g., Colorado PUC, Pennsylvania Office Of Consumer Advocate, Texas PUC.

After a carrier has filed proposed depreciation rates with the FCC, and the states have been notified of the proposal, the states will have ample ability to comment and request additional information, either directly or through the FCC. The price cap carrier option does not undercut the ability of either the FCC or the states to regulate telecommunications. It simply accords the Telephone Companies the necessary flexibility to achieve appropriate depreciation rates, and eliminates a mass of unnecessary paperwork.²⁷

F. Other Depreciation Options

In general, most state commission commenting parties have expressed support for the basic factors range option²⁸ and, to a lesser extent, the range of depreciation rates option.²⁹ However, we have shown the price cap carrier proposal to be superior to these options in meeting the objectives of the Commission. The basic factors range option and the range of depreciation rates option, especially the latter, could improve the depreciation process only if properly

27 CCTA states that simplification will sacrifice the "accurate quantification of depreciation expense" (p. 8). Such "accurate quantification" is simply an exercise in measuring history. Prediction of the future is an approximation at best. The current depreciation process, by insisting on masses of data, imbues that prediction with an apparent precision that it can never actually have.

28 E.g., NARUC, NY DPS. This option would establish ranges for the basic factors that determine the parameters used in the depreciation rate formula.

29 E.g., Washington Utilities and Transportation Commission. This option would establish ranges for depreciation rates.

modified.³⁰ Among other things, as pointed out by CCTA (pp. 14-21), the range-setting proposals in the NPRM are much too narrow for the wide variances in account positions which already exist among the LECs. Many of the LECs could face serious account imbalances in conforming to such ranges. In this regard, NARUC appropriately recommends (p. 11) that carriers retain the option of a full depreciation study for particular accounts.³¹

Finally, the Commission's depreciation schedule option³² has been universally opposed in the comments -- e.g., because of its complexity, retrospective focus and inaccuracy -- and should be discarded.

III. THE CURRENT TREATMENT OF SALVAGE IN THE DEPRECIATION PROCESS SHOULD NOT BE CHANGED

There is broad, but not universal, agreement in the state commissions' comments that net salvage should be charged to expense in the year incurred, instead of being subsumed in depreciation rates as it is currently. This agreement, however, is usually qualified with the suggestion that salvage treatment is a complex issue and should be considered in either a second stage to this proceeding or in a new proceeding.³³

³⁰ NTCs 13-19.

³¹ However, NARUC's suggestion (p. 7) of a 5 year interval between updates of ranges would prevent timely responses to dynamic marketplace factors, and should not be adopted.

³² This option would establish a depreciation schedule for each plant account.

³³ E.g., NY DPS.

Telephone Company assets are such that this treatment could cause intergenerational inequities, and this treatment would be a marked departure from the depreciation principle of matching capital recovery to consumption. At present, there are accounts for which the net salvage (negative) is a considerable percentage of the original book cost. In these accounts, primarily outside plant, the gross salvage value of the plant is negligible and the cost of removal and disposal is very high. It is very possible that future environmental regulations affecting disposal of telecommunications plant could make these costs of removal even higher, thereby increasing the potential for even more intergenerational inequities.

Additionally, the net salvage amount incurred is very volatile on a year to year basis. Standard depreciation study techniques use banded analysis for salvage to smooth this volatility. Recovery of the often negative salvage amounts is further smoothed by incorporating salvage into depreciation and recovering it over the life of the equipment. Expensing salvage on a yearly basis would inject a volatile expense into the company's financials. Also, parties espousing a change in salvage techniques are silent on how to ensure recovery of an expensed salvage. For the above reasons, the Commission should retain the present depreciation treatment of salvage, but in any case not make any changes without further proceedings to explore the complex issues involved.

IV. CONCLUSION

The record supports the Commission's adoption of the price cap carrier option as striking the best balance in accomplishing the objectives of this proceeding.

Respectfully submitted,

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Attachment to NTCs' Reply Comments,
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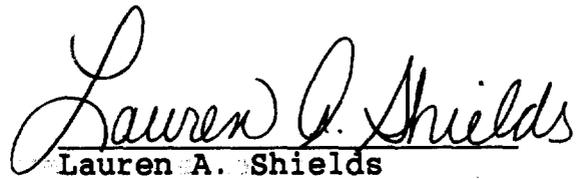
| Depr. Expense Change vs. ROR Change | | | |
|---|--------------|--------------|--------------|
| Ln No. (\$000) | New England | New York | NTCs |
| 1 1991 Depreciation | \$781,744 | \$1,382,787 | \$2,164,531 |
| 2 1991 TPIS (less land) | \$10,973,482 | \$17,318,363 | \$28,291,845 |
| 3 Effective Depr. Rate (Line 1/Line 2) | 7.1% | 8.0% | 7.7% |
| 4 1% Increase in Depr (.01*Line 1) | \$7,817 | \$13,828 | \$21,645 |
| 5 1991 Avg. Net Invest * | \$6,368,072 | \$11,147,520 | \$17,515,592 |
| 6 Impact on ROR ((Line 4*(1-.34)/Line 5) | -0.08% | -0.08% | -0.08% |

* $((1991 \text{ Net Plant} + 1990 \text{ Net Plant})/2) - (\text{Depr. Incr.}/2)$

Data from 1990 and 1991 Form M Reports

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing REPLY
COMMENTS OF THE NYNEX TELEPHONE COMPANIES, was served by first
class United States mail, postage prepaid, on each of the
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