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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	))))	CC Docket No. 93-251

GTE's REPLY COMMENTS

GTE Service Corporation and its affiliated domestic telephone operating companies

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GTE's REPLY COMMENTS

GTE Service Corporation and its affiliated domestic telephone operating companies ("GTE") hereby submit reply comments with regard to comments filed in response to the Notice of Proposed Rulemaking, FCC 93-453 (released October 20, 1993) (the "*Notice*" or "NPRM") concerning the Commission's rules governing proper regulatory accounting under the Uniform System of Accounts ("USOA") for transactions between carriers and their nonregulated affiliates (the "*Affiliate Transaction Rules*").[1] These rules have been applied through the vehicle of specific line-by-line review of a Cost Accounting Manual ("CAM") for each Local Exchange Carrier ("LEC" or "exchange carrier") covered by the *Affiliate Transaction Rules*.[2]

Enumerated in the comments of USTA are safeguards against cross subsidy, ranging from Generally Accepted Accounting Principles ("GAAP") to CAMs to ARMIS

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1 The *Affiliate Transaction Rules* have been included in Part 32 of the Uniform System of Accounts. *See* Separation of costs, CC Docket No. 86-111 ("D.86-111"), Report & Order, 2 FCC Rcd 1298 (1987); *modified*, Order on Reconsideration, 2 FCC Rcd 6283 (1987); *further modified*, Order on Further Reconsideration, 3 FCC Rcd 6701 (1988); *aff'd sub nom.* Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990) ("*Southwestern Bell*").

2 *See, for example, GTE's CAM* (AAD 7-1690), 3 FCC Rcd 3573 (1988), *supplemented*, 4 FCC Rcd 2205 (1989).

reporting to independent audit requirements[3] to on-site audits to the influence of the marketplace. The totality of these safeguards subject exchange carriers to searching, detailed and continuous scrutiny far exceeding the Commission's needs. The *Notice* would create still another level of accounting requirements.

DISCUSSION

I. A BROAD CONSENSUS OF COMMENTING PARTIES MAINTAINS THE COSTS AND BURDENS ASSOCIATED WITH THE PROPOSED RULES WOULD FAR EXCEED ANY CONCEIVABLE BENEFITS.

GTE's comments stressed that adoption of the proposals set forth in the *Notice* would dramatically increase regulatory costs and burdens[4] without improving the quality of relevant information available to the Commission.[5] The filed comments provide further substantiation for GTE's position.

As Bell Atlantic states (at 1), the proposed rules are a "step backwards" in that they are inconsistent with the FCC's policies that promote efficiency, foster competition and reduce regulatory burdens. Further, Bell Atlantic (at 4) contends, the Commission

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[3] The scope, complexity and cost of the independent audit requirement was greatly increased in Computer III Remand Proceedings, CC Docket No. 90-623, Report and Order, 6 FCC Rcd 7571 (1991), *petitions for review pending sub nom.* California v. FCC, No. 92-70083 (9th Cir. filed February 4, 1992). This audit requirement will be still further extended under the *Notice* at paragraph 98.

[4] GTE (at 2) estimated the added costs for GTE that would be generated as a result of adopting the proposals and tentative decisions of the *Notice* at $11.5 million, of which $3 million would be directly associated with obtaining market valuations for services. USTA, addressing the question of cost on an industrywide basis, estimated total added cost for the industry at $91 million.

[5] GTE (at 3) showed that the effect of such an adoption would merely accumulate more and more detail with less and less relevance to the task of the Commission.

does not "cite one shred of evidence that the current rules are insufficient or ineffective."[6]

As stressed (at 2) by the United States Telephone Association ("USTA"), even the current rules governing affiliate relationships go beyond the Commission's objectives. Cincinnati Bell (at 1) maintains the proposed rules are unnecessary and would impose an unwarranted burden. Ameritech (at 6) says the Notice does not provide a "reasoned analysis" supporting the conclusion that the current rules are insufficient and the proposed rules are needed. Similarly, BellSouth says (at iii) the proposed rules are unnecessary and the *Notice* does not represent rational decision-making, and (at 9) the costs associated with the proposed rules would outweigh any possible benefit.

US West (at 6) says present accounting safeguards are sufficient, just as NYNEX (at 2) contends the proposed rules are unwarranted. Southwestern Bell, pointing out (at 1) that the proposed rules are unnecessary, and that these proposals are based not on facts but on speculation, adds (i):

> The proposals in the NPRM are detrimental to all involved -- the Commission, the carriers, the ratepayer and the shareholder. The only group benefitting from the proposal will be carrier's competitors who are not bound by the rules and thus do not have to incur the unnecessary regulatory burdens and cost of trying to comply.

At a minimum, it must be said that the pleadings cited, together with thoughtful comments raised by such parties as Coopers and Lybrand, raise the most serious questions about the wisdom of the course of action contemplated by the *Notice*. GTE

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[6] The International Communication Association, which favors the proposed rules, stresses (at 6) the need for the Commission to provide more details and citations to support its conclusions. GTE maintains there has been no demonstration that the current rules, combined with the FCC's active program of enforcement, do not provide sufficient protection for the ratepayer. Surely the adoption of far more burdensome regulations must be grounded on identified problems that have arisen rather than a feeling (*Notice* at paragraph 9) that present rules "may not be optimal."

joins USTA and the other parties, *supra*, in suggesting the record dictates a Commission decision putting aside the unfortunate proposals of the *Notice*.

The change in Commission rules proposed by the *Notice* would move FCC regulation in the wrong direction. It would require generation of more and more regulatory accounting data as, under price caps, that additional data are becoming less and less significant. By the same token, it increases regulatory burdens unique to exchange carriers as exchange carriers face increased competition.[7]

Established Commission policy points in precisely the opposite direction. The FCC's policy, which calls for the elimination of unnecessary regulation, recognizes that real competition providing real benefits to customers cannot be achieved unless exchange carriers are permitted to compete with lightly regulated and unregulated firms.

The International Communication Association ("ICA") claims (at 3) that the LEC's "major revenue streams are virtually exempt from competition...." This is an astounding statement given that MCI has made worldwide headlines[8] when it officially announced its intention to spend billions of dollars entering eighty to a hundred markets where it will compete head-to-head with exchange carriers. This provides dramatic evidence of the growing rate at which competition is flooding into LEC markets. ICA's comment must be dismissed as being out-of-date by at least ten years.

In contrast, the FCC's policy recognizes the reality of local exchange competition and seeks to decrease regulatory burdens unique to exchange carriers in order to allow LECs to compete. This was recently addressed in the context of the Commission's CC

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[7] The increased competition faced by exchange carriers was shown by GTE at 4-7.

[8] *See for example MCI Is Planning Local Networks In Major Cities*, THE WALL STREET JOURNAL, December 20, 1993, which describes MCI's plan to build networks in eighty to a hundred markets.

Docket No. 91-141 ("*D.91-141*").[9] "[I]n order to encourage efficiency and full competition", the *D.91-141 Phase I Order* says, exchange carriers "should -- indeed must -- be allowed to offer reasonable volume and term discounts."[10] Further, it says: "As a general matter, if volume and term discounts are justified by underlying costs, and are not otherwise unlawful, the LECs should -- indeed must -- be allowed to offer them in order to encourage efficiency and full competition."[11]

Part of this policy is the Commission's incentive regulation plan[12], discussed further *infra*, which was designed to free exchange carriers facing competition of regulation that would have counter-efficient consequences. Thus, the proposals of the

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9 Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141 ("D.91-141"), Second Report and Order and Third Notice of Proposed Rulemaking, FCC 93-379 (released September 2, 1993) (the "*D.91-141 Phase I Order*").

10 *D.91-141 Phase I Order* at paragraph 115, footnote omitted, emphasis added.

11 *Id.* at para. 115, footnote omitted. In the case of AT&T, the Commission has taken appropriate action to reduce regulatory burdens with increasing competition. Competition in the Interstate Interexchange Marketplace, Report and Order, CC Docket No. 90-132, 6 FCC Rcd 5880, 5881-82 (1991).

12 Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313 ("D.87-313"), Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989), and Erratum, 4 FCC Rcd 3379 (1989), ("*D.87-313 Report & Order*"), Second Report and Order, 5 FCC Rcd 6786 (1990), and Erratum, 5 FCC Rcd 7664 (1990), ("*LEC Price Cap Order*"), *modified on recon.*, 6 FCC Rcd 2637 (1991) ("*LEC Price Cap Reconsideration Order*"), *aff'd. sub nom.* National Rural Telecom Association, 988 F.2d 174 (D.C. Cir. 1993).

Notice, if adopted, would operate in complete opposition to the FCC's established policy.[13]

In GTE's view, the NPRM proposals should be put aside. Alternatively, as recommended by a number of parties[14], consideration of these proposals should be deferred until the Commission completes its review of the results of price caps and shapes its new price caps policy. Then, the question of whether a continued sharing feature of incentive regulation will be determined. Since this sharing question is a keystone of the Notice's recommendations, it will then be possible for the Commission to address the NPRM proposals. Otherwise, the industry might be required to incur massive expenditures only to find that price cap policies are changed in fundamental ways that would require further changes in accounting rules.

In summary: As reflected in filed comments, the costs of the more burdensome rules proposed by the Notice would far exceed any conceivable benefit; and these proposed rules, if adopted, would have effects directly opposite established Commission policy.

II. THE RECORD SHOWS THAT THE PROPOSED RULES ARE AT ODDS WITH INCENTIVE REGULATION.

The clear conflict between the proposed rules and the FCC's plan for incentive regulation -- or "price caps" -- is described by a number of commentors. "While the Commission pays lip service to the incentives promoted by price caps," suggests

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13 FCC Chairman Reed Hundt was recently quoted saying: "I would hope that, in the end, we will have a more simplified regulatory scheme. I do not think that regulation or deregulation is an end in itself.... I am a firm believer in the economic advantages of competition, which is the best model for economic growth." *See* "New FCC Chief Signals Change", COMMUNICATIONS WEEK, December 6, 1993 at 1, 86.

14 BellSouth (at 8-9), US West (at iv), Ameritech (at 8), and Bell Atlantic (at 7).

Ameritech (at 7), the "draconian accounting requirements" proposed by the *Notice* "in actuality disregard[ ] the significant impact price caps have had on LECs' actions." Southwestern Bell (at 18) suggests that the logic of the *Notice* "appears to be that because the Commission has correctly increased incentives to be more efficient by introducing price cap regulation, it can retract other incentives to be efficient." This logic (*id.*) "suggests that trends toward better, more efficient regulation may be interrupted by worse, less efficient regulation without justification."

GTE suggests the NPRM proposals should be subjected to searching scrutiny in relation to the Commission's constructive and forward-looking policy of incentive regulation. Such an examination would show that adoption of these proposals would dramatically increase accounting requirements for price cap companies and would conflict with the whole thrust of Commission policy centered on incentive regulation. Not only would adoption of these proposals engage the Commission staff and company accountants in the same exhaustive accounting effort as if price caps did not exist; it would require an even more extensive effort to gather detailed accounting data even though the likelihood that that data will have any significant bearing on rates is far less than ever before.

With regard to claims that the "sharing" provision of the price caps rules requires adoption of the NPRM proposals, it is significant that GTE's rates are generally below price cap levels. Inasmuch as the sharing provision does not lead to refunds but only to an index (PCI) revision for the next year,[15] and with GTE's rates below price cap levels, it cannot be assumed that the sharing provision will have any impact whatever

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[15] "[T]he sharing mechanism operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings...." *LEC Price Cap Order*, 5 FCC Rcd at 6803.

on GTE's rates. Thus, the proposals of the Notice would be likely to have little or no effect on the rates of carriers in the position of GTE.[16]

In any case, the Commission must make certain that sharing -- a "backstop", a secondary device -- is not permitted to defeat the purpose of the price caps plan.[17] Incentive regulation is designed to assure protection of the public interest while avoiding the pointless complexities and irrational consequences of the rate of return system. In 1989, the Commission said: "Our interest in formulating an alternative regulatory approach for dominant carriers stems directly from our concern with the drawbacks of rate of return regulation."[18]

In the course of several years of consideration, the price cap plan was fashioned to avoid these drawbacks. The sharing device was carefully described as simply a "backstop"[19] -- not as an inversion of the entire plan and a return to the very irrationalities the plan was constructed to escape. An approach that, in the name of a mere backstop, leads FCC regulation right back to the very same drawbacks collides with the clear intent of the Commission's own policy. There is no justification for citing

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[16] In terms of eventual effects, it should be remembered that sharing was designed to protect carrier investors as well as ratepayers, so sharing might ultimately lead to increased rates.

[17] Under price caps, it is improper even to speak of overearnings. Earnings over the upper threshold are shared with the customers through adjustments in the PCI.

[18] *D.87-313 Report & Order*, 4 FCC Rcd at 2922. Measuring alternative regulatory methods against the rate of return system, the Commission identified five flaws in rate of return regulation: (1) it provides incentives for carriers to be inefficient; (2) it provides carriers with insufficient incentives to encourage innovation; (3) it tends to foster cross-subsidization and inability to move toward an optimally efficient set of prices; (4) its administrative costs are high; and (5) consumers are better off under incentive regulation than under rate of return regulation.

[19] *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2683-84; *LEC Price Cap Order*, 5 FCC Rcd at 6801.

the sharing mechanism -- which was adopted merely as a backstop -- to undermine the objectives of the Commission's plan for incentive regulation.

In summary: The record of this proceeding demonstrates that the proposed rules are at odds with incentive regulation.

III. FILED COMMENTS SUPPORT THE PREVAILING COMPANY PRICE CONCEPT OF THE CURRENT RULES.

In addressing the question of showing fair market value, the starting point should be the broadly accepted definition of the term, which is furnished by Ameritech (at 12):

> The definition of estimated fair market value is generally accepted to be: the price at which a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts, complete a transaction.

The question, then, is essentially factual, and it relates to the operation of a market -- a subject that can be addressed through recognized principles rather than arbitrary rules imposed by sheer power. The Commission itself considered this question at length in D.86-111 and concluded the most feasible way to approach this showing is by the concept of prevailing company price. GTE suggests nothing whatever has occurred -- and no event is cited in the *Notice* -- that would justify abandoning the prevailing company price concept as proof of fair market value.

In GTE's view, the prevailing company price concept of the current rules provides an effective means of protecting the ratepayer by relying on the competence and self-interest of the unaffiliated purchaser. Similar thoughts have been expressed by a number of commentors. As NYNEX phrases it (at 24):

> This rule is based on the sound theory that if third parties are willing to pay such price in arm's length transactions with a willing seller, then the price is a good indicator of value and is reasonable for recognition in affiliate transactions.

Pacific (at 10) says: "As long as an affiliate has significant or substantial transactions with nonaffiliates and the carrier is charged the same price as those nonaffiliates, the

Commission's concern about the carrier being overcharged as a captive audience is not warranted, and the prevailing price should be presumed to be fair." SPRINT (at 6) says: "[I]n an open market and where competition exists between suppliers, substantive sales to nonaffiliates legitimately establish market value at that point in time."

Under the prevailing company price concept of the current rules, the focus is on the unaffiliated purchaser.[20] The fair assumption is made that corporate purchasers acting in the interests of their firms are likely to be knowledgeable about the product-price mix available on the market (*i.e.*, have reasonable knowledge of the relevant facts), to be motivated to find the mix most suitable to their firms' objectives, and to be able to make competent decisions in this direction (*i.e.*, not being under any compulsion to buy).

This concept is sound because it fairly relates to established principles and long experience with markets and the way they work. As phrased by BellSouth (at 21), the "rationale behind the rule is that a third party's willingness to buy a product or service in substantial quantities at the offered price provides a reasonable assurance that the prevailing company price is reasonable." To determine fair market value, the rule looks at market reaction in particular cases where a willing buyer makes an independent decision to make a purchase -- and the frequency and volume of those purchases have to be enough to show that knowledgeable corporate purchasers are willing to buy the product in question at the price in question. This deals with a factual question under normal and logical rules of factual analysis and probative evidence. As expressed by Cincinnati Bell (at 2):

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[20] *See U S West's CAM*, 4 FCC Rcd 481, 486 (1989) (Chief, Common Carrier Bureau): "Because unaffiliated persons and entities will have no incentive to subsidize U S West's operations, the prices should be sufficient to cover U S West's costs." Footnote omitted.

> [I]t is highly improbable ... for an entity to sell any substantial quantity of a product or service to a non-affiliate at a price which was anything other than fair market value driven.... [E]xistence of substantial quantities of non-affiliate transactions lead to the inescapable conclusion that the pricing of those transactions is realistically market driven....

Further, Cincinnati Bell (*id.*) correctly stresses the reliability of this conclusion "so long as there are any substantial number of non-affiliate transactions...." This matches the thought of AT&T (at 18): "A market price is established if any significant group of market participants engages in an arm's length transaction at that price."

But the *Notice* insists the prevailing company price rule must be modified by excluding cases where the unregulated affiliate involved in the transaction (*UNREG*) cannot show that seventy-five percent of its business is with external parties. As stressed by Southwestern Bell (at ii), "Percentages of output have nothing to do with trying to determine the market price; the inquiry should be a substantial number of sales to nonaffiliates as it is under the current rules." **This introduces an element completely alien to the market concepts and the logic underlying the Commission's own rule.**

The *Notice* insists on focusing on whether the sale to unaffiliated parties represents a large or small ratio of total sales by *UNREG*. This imposes a concept that has no logical nexus to how the market can be expected to react. There is no reason whatever to believe that unaffiliated purchasers would be willing to pay any more, or any less, based on the ratio of *UNREG*'s sales to unaffiliated parties to *UNREG*'s total sales. Neither commenting parties nor the *Notice* even attempt to argue that the price unaffiliated purchasers would be willing to pay would vary depending on this ratio -- a ratio that has no bearing whatever on the factors competent and motivated unaffiliated corporate purchasers would take into account in deciding whether to purchase. The imposition of this ratio, then -- at seventy-five percent or any other level -- would violate rules of evidence and due process, would be arbitrary and capricious.

Assume *UNREG* sells a million dollars worth of a particular product at a particular price to a number of unaffiliated parties. In dealing with the identification of fair market value, to decree that these purchases are not probative of fair market value merely because *UNRREG*'s total sales to unaffiliated purchasers do not amount to a certain ratio of *UNREG*'s sales is no more coherent, no more consistent with the logic of the rule itself, than if the test were related to *UNREG*'s ratio of out-of-state income to total income, or *UNREG*'s ratio of occupied floor space to total floor space, or *UNREG*'s ratio of stockholders to employees. By the same token, **there is no logical nexus between the idea of a ratio test based on *UNREG*'s external versus total sales and the nature and purpose of the prevailing company price test and what it is designed to measure: fair market value.**[21]

The *Notice* (*id.*) offers no connection between the logic of the prevailing company price rule and the proposed seventy-five percent test.[22] It simply pronounces a tentative conclusion that a given percentage is appropriate to link two totally unrelated concepts. Its purpose appears to be to eliminate the prevailing company price test as a practical matter without formally eliminating the rule.

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21 It is also true, as SNET points out (at 7), that there would be grave difficulty in setting a single standard that would make any sense whatever. "[T]he prescription of any single percentage of output for all LECS, all their corporate structures, and all their relationships with affiliates would not only be arbitrary, but basically unworkable. Each LEC corporate structure is unique, and responds to individual corporate objectives, market conditions and many other factors too numerous to elaborate here.... It would be arbitrary, unfair and in disregard of reality to prescribe a single percentage as the one and only gauge for 'output' to nonaffiliates for every LEC, across all affiliates. Simply one size does not fit all." A similar point is made by USTA (at 19-21).

22 NYNEX (at 26) points out an anomaly in the NPRM proposals: When establishing fair market value for comparative purposes, the FCC will allow a "single bid as constituting an accurate determination of fair market value. On the other hand, the NPRM assumes that it is necessary to look at 75% of actual sales to determine an accurate fair market value for goods and services provided both to the external market and to affiliates."

The prevailing company price concept can provide reasonable protection for the ratepayer without reintroducing the rigidities and economic irrationalities the Commission sought to escape in adopting price caps. It is a concept far more suitable to a regulatory environment where the decision has been made to step back from rate of return regulation. In contrast, mandating the assembly of still more massive amounts of data -- which then must be more extensively covered by independent auditing firm certification[23] -- expends industry and agency resources to provide data that is generally irrelevant to the role the Commission is playing -- and indeed still more lacking in relevance as the industry leaves far behind a closed-market environment and as traditional regulatory accounting issues lose significance.

In GTE's view, any test devised to assure protection of the ratepayer should reasonably relate to the logic of the prevailing company price standard. This means any such test should look at facts indicating market reaction. Clearly, the dimensions of the sales to unaffiliated parties is relevant, as are: (i) the number of *bona fide* purchasers for amounts that are not trivial and (ii) the growth in sales volume. Also relevant is data on what is generally offered in the marketplace by unaffiliated vendors. All of these criteria have a reasonable relationship to what is being considered: the evidence provided by the marketplace showing the competitive validity of the product-price offering to the affiliated LEC. As well put by US West (at 18),

> [I]t is clear that the purpose for the existence of the seller or buyer has absolutely nothing to do with fair market value. The only issue that matters is ascertaining whether prevailing company prices represent the fair market value of goods and services in the environment in which the prices were set.

From the point of view of the company, an important consideration is that any test adopted should provide reasonably understandable, objective and predictable results. This is because by its nature such a test would have an important bearing on

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23 *See* the *Notice* at paragraph 98.

the long-term planning of the company. In contrast, the Commission's accounting arm is by definition not engaged in making decisions with long-term consequences; it is reviewing the results of the company to assure compliance with the Commission's Rules. Any test fashioned for this purpose, then, should be designed to provide a "safe harbor" for the company, *i.e.*, assurance that, if the LEC's figures come within certain parameters, the validity of the pricing will be accepted. For example, US West (at 18) makes the constructive suggestion that "the Commission should consider promulgating a rule that a sale to some minimum threshold number of third-party customers (such as three) would be required to establish that prevailing company prices represent fair market value." Whether three would be the appropriate number is open to discussion, but at least this test has the virtue of relating to what is being tested: market reaction. Significantly, US West also (at 19) makes the point that "[s]ales to less than a threshold number of outside customers do not prove that prevailing company prices are not set at fair market value." In other words, in harmony with GTE's "safe harbor" suggestion, any test employed should not preclude the possibility of the prevailing company price standard being satisfied by other kinds of showings.

In summary: Filed comments support the prevailing company price concept of the current rules -- which provide an effective means of protecting the ratepayer by relying on the competence and self-interest of the unaffiliated purchaser.

IV. FILED COMMENTS DEMONSTRATE THAT THE *ASYMMETRIC RULE* APPLIED TO SERVICES WOULD CREATE VAST ADMINISTRATIVE PROBLEMS AND COSTS EXCEEDING ANY CONCEIVABLE BENEFIT.

The *Notice* (at paragraph 34) tentatively concludes the Commission should adopt what would amount to an entirely new Rule for services which -- except for LEC tariffed offerings and prevailing company price cases[24] -- would require the LEC for both assets and services to treat a transaction on either a cost or fair market value basis -- whichever is the more unfavorable to the investor.[25] This GTE will refer to this as the "*Asymmetric Rule*" since the Rule will produce an asymmetric result.

A number of commentors stressed the room for subjectivity in the proposed *Asymmetric Rule*, under which not only assets but services are valued based on fair market value or cost, whichever is more unfavorable to the investor. Coopers and Lybrand (at 4) suggests that the *Asymmetric Rule*, in addition to greatly increasing auditing requirements, will be contested because it would add "substantial subjectivity to the rules." SPRINT (at 19) says: "Estimated fair market value cannot work for valuing services because any weight given to the three key valuation factors--comparability, availability, capability--is completely subjective and easily manipulated." Similarly, Southwestern Bell (16) says:

> Reams of paper will no doubt be filed by carriers and their opponents arguing over what is the "proper" estimated fair market valuation. Endless hours will be spent by carriers trying to establish and the Commission trying to audit and otherwise monitor the estimated fair market value. Yet the fair market valuation will remain only a subjective, arbitrary estimate and the carriers subject to claims of manipulation no matter how the estimate is developed.

BellSouth (at 26) stresses the difficulty of fair market value assessment for holding company services.

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[24] As indicated *supra*, the seventy-five percent Rule would be likely to preclude prevailing company price as a practical matter.

[25] "[W]e tentatively conclude that we should require carriers to record all affiliate transactions involving the provision of services, other than those provided pursuant to tariff or permitted to be recorded at prevailing company prices, at the higher of fully distributed costs and estimated fair market value when a carrier is the seller, and at the lower of fully distributed costs and estimated fair market value when a carrier is the purchaser." *Notice* at paragraph 34.

Several parties suggest the effect of adopting the *Asymmetric Rule* would be to preclude affiliate relationships that would otherwise offer important benefits. Thus, Southwestern Bell (at iii) says:

> The result of requiring such estimates will likely be that carriers will determine that for certain services, the expense associated with complying with the regulatory burdens is not worth the benefits received from providing the service. Thus, the ratepayer will lose the economies of scale and contributions to common expenses generated by such services.

Southwestern Bell (at 26) goes on to express its concerns about the loss of savings that could be provided by centralization of services. NYNEX (at 18) suggests that market valuation is simply inapplicable to corporate governance and ownership functions. GTE (at 17) suggests:

> The cumulative result of these Affiliation Penalties would be to place an exchange carrier's unregulated affiliate at a grave disadvantage vis-a-vis unaffiliated parties. The unintended effect of this accumulation could be denying customers the benefits of proper affiliate relationships. Indeed, the imposition of the plethora of entirely new and complex accounting requirements proposed by the *Notice* is intelligible only if it is assumed that a policy decision has been reached that disfavors affiliate relationships.

And yet the FCC has never decided that affiliate relationships are for some reason undesirable. The employment of unregulated affiliates has been shown to realize great savings and benefits.[26] These can arise from the economies of scale inherent in the provision of service by a centralized provider, including the employment of experts who can learn lessons of broader application as they deal again and again with similar problems at many separate locations. Having this expertise available to the individual exchange carrier can free its management to concentrate on more urgent matters or on activities more central to its core business interests. Further, the implementation of "system standards" can produce the very important economy of being able to address the same essential situation at ten or twenty or fifty locations

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[26] GTE has demonstrated these benefits in countless state proceedings.

across the country, using the expertise developed at one or two locations.[27] Standardized management systems can be employed on a system-wide basis to deal with, for example, maintenance of inventories. Compliance with government regulations is another notable area where there are important economies of scale involved.[28]

Pacific Bell (at 14) says the Asymmetric rule will "result in a subsidy from the nonregulated affiliate to ratepayers." BellSouth (at 23-24) urges the Commission to change the asymmetrical rule even for assets. US West (at 22-23 and 28) provides a very useful discussions of how assets and services should be defined and shows why treating services and assets differently under the current rules should be retained.

The record demonstrates that the costs of such a Rule on an industry basis would be staggering. What would be the benefits? Even making the (bad) assumption that the interests of ratepayers amount to simply lower rates, it cannot be expected that this vast expenditure would produce lower rates for ratepayers. Further, the relative burden borne by exchange carriers compared to their competitors would be further increased just at a time when competition is increasing. The resources of the

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27 Further economies of scale can be obtained in the procurement of materials and supplies, where aggregating the purchases of the entire system can generate volume-related price reductions and reduced inventory carrying costs, as well as other favorable contract terms. Procurement of complex systems designed or modified to meet an exchange carrier's particular needs becomes practical for a company that is a large enough purchaser of systems.

28 Evidence of this is found in the pattern of FCC action, where much more demanding regulations are applied to the large or the very large companies with centralized staffs than to smaller companies. The difference in the severity of rules as written and applied by the FCC itself recognizes that companies with a centralized staff realizing the economies of scale discussed *supra* are better able to meet compliance requirements at reasonable cost.

Commission would be diverted from more productive activity. And another step would be taken toward undermining the whole logic of incentive regulation.[29]

In summary: The filed comments show that the costs of the Asymmetric Rule would be immense, far greater than any conceivable benefit, and such a rule would do serious damage to Commission policy objectives.

V. THE FILED COMMENTS SUPPORT THE CONCLUSION OF THE *NOTICE* THAT THE CONSEQUENCES OF CHANGES TO THE USOA SHOULD BE GIVEN EXOGENOUS TREATMENT.

The comments reflect no opposition to the conclusion reached in paragraph 36 of the *Notice*:

> The valuation methods we propose in this *Notice* would change the USOA requirements for affiliate transaction accounting. In the price cap proceedings, the Commission determined that changes to the USOA should generally be treated as exogenous. In view of that determination, we tentatively conclude that any changes we make in the valuation methods for affiliate transactions should be exogenous.[30]

When the Commission makes changes to the affiliate transaction valuation methods the total impact of such changes should be treated as exogenous for price caps purposes. This treatment includes not only the changes brought about by the valuation methods themselves, but also includes the increased recurring administrative costs that are attributable to those changes. Clearly the increased recurring administrative costs are just as "outside the control of carriers" as the valuation impacts themselves.

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[29] As pointed out by GTE (at n.24) the Commission itself has long rejected employment of any market-related test apart from prevailing company price. The *Notice* contains no explanation of how a standard totally unacceptable heretofore because of its unreliability can now be imposed on LECs on a mandatory basis.

[30] Footnotes omitted.

Exogenous treatment is supported even by MCI, which states (at page 8): "While exogenous treatment would similarly pass any resulting increases in rates to the ratepayer, MCI does not believe that this is likely to happen." GTE believes MCI does not have an appreciation for the enormous costs that will be associated with the proposed rules as opposed to any minor impact caused by the changes to valuation methods. Exogenous treatment may very well cause rates to increase.

In summary: The record of this proceeding supports the conclusion of the *Notice* that the consequences of changes to the USOA should be given exogenous treatment.

VI. AS A RATE OF RETURN COMPONENT, GTE SUGGESTS THE FCC SHOULD EMPLOY THE AUTHORIZED RATE OF RETURN.

In GTE's view, the rate of return employed for accounting purposes should be the authorized return.[31] This avoids the need for true-up with its attendant complications and costs. It also recognizes the FCC's authority by using a single, interstate rate of return for the purposes of applying the *Affiliate Transaction Rules*.

VII. THE COMMISSION SHOULD CONTINUE TO REJECT PROPOSALS THAT WOULD INVOLVE DECIDING MATTERS FAR BEYOND THE APPLICATION OF ACCOUNTING RULES AND FAR BEYOND ANYTHING THAT EXISTS IN THE RECORD OF D.86-111.

The Tennessee commission continues its effort to shift the whole purpose and effect of the FCC's *Affiliate Transaction Rules*. These are accounting rules designed to provide information. The Tennessee commission would turn these rules into a means for agency prescription of the terms of doing business.

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[31] Whatever the merits of regulatory action determining nonregulated affiliates' cost by imputing a limit on their rate of return, no rate of return lower than the authorized level would be consistent with the logic supporting any such imputation.

The question of "subsidy" illustrates the point. Absent a relevant tariff provision or prevailing contract price, the FCC looks at cost as defined under its rules. If the cost standard is met, the FCC has assured itself that there is compliance with its standard designed to protect the ratepayer from being disadvantaged.

A "subsidy" occurs if *UNREG* pays for services rendered a dollar more than cost, or if *UNREG* is paid for services rendered a dollar less than cost. The sensible rule currently applied is that, in both of these cases, the FCC's concerns are satisfied. This follows logically from the nature and purpose of the *Affiliate Transaction Rules.*

Thus, on a sale by the carrier to *UNREG* when there is full recovery of cost (including the appropriate rate of return) plus subsidy, the ratepayer is in at least as good a position as if an incremental element of regulated business had been brought in by the carrier's sales force. On a transaction in the opposite direction, a sale to the carrier by *UNREG*, so long as the cost standard has been met, the ratepayer is assured there have been no profits earned by *UNREG* beyond the level of reasonableness.

The Tennessee commission wants the FCC to go beyond accounting concerns to the prescription of appropriate terms of dealing; and any departure from such terms (any "alternative methodology") would require the equivalent of an FCC waiver -- which in turn would depend on the approval of the relevant state commission(s). Thus, the Tennessee commission says (at 4-6):

> If an alternative methodology is to be used, it should be fully described in the CAM and allowed to be implemented only after review and approval by the FCC. Such approval should be granted only after the state Commissions have had an opportunity to thoroughly investigate and provide comments on the proposal to the FCC. No alternative pricing methodology should be allowed unless it can be demonstrated that it is beneficial to either the regulated interstate or intrastate operations of the carrier. Furthermore, even if the interstate jurisdiction is not affected by the transaction (yellow pages) the FCC should require the same justification from a carrier before it is allowed to use an alternative pricing method as it would if the interstate jurisdiction were impacted.

As a related matter, the *Notice* (at paragraphs 37-39) raises the possibility that the FCC's standard might not be satisfied by a showing that the net effect of an affiliate transaction exceeds the mandated level, *i.e.*, provides a subsidy.

GTE urges the FCC to continue its established policy as reflected in the Common Carrier Bureau's recent Order[32] that did not require changes in GTE's contractual relationships.

Either acceding to the position of the Tennessee commission or accepting the proposals of NPRM paragraphs 37-39 would necessarily involve the FCC in deciding the acceptability of various forms and levels of subsidy. On the sale to *UNREG*, is a subsidy of one dollar more than cost sufficient? Should it be two dollars more? Two thousand dollars more? On the sale by *UNREG*, the same questions arise. Should regulatory action require a subsidy? If required, at what level should the requirement be set? Established by what standard? With what outer limits? These quickly emerge not as accounting questions at all, for they are not concerned with providing information on which sound regulatory action can be based; they are concerned with what amounts to ratemaking.

If the FCC unwisely involves itself in these questions, it would necessarily have to initiate a new proceeding, for D.86-111 did not consider any questions of this sort. A set of entirely new standards would have to be created based on an entirely new proceeding -- a proceeding that would have to take account of the great range of differing views and policies of the fifty states.

The FCC's focus in these rules should continue to be no harm to the ratepayer. Having satisfied itself that the cost standard has been satisfied, the FCC's inquiry should be at an end.

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[32] Local Exchange Carriers' Permanent Cost Allocation Manuals for the Separation of Regulated and Nonregulated Costs, AAD Nos. 92-22 through 92-35, 8 FCC Rcd 3105 (By Chief, Common Carrier Bureau).

In summary: The FCC should continue to reject the arguments of the Tennessee commission and should put aside related proposals of NRPM paragraphs 37-39 which would involve the FCC in deciding "subsidy" matters far beyond the application of accounting rules and far beyond anything that exists in the record of D.86-111.

Respectfully submitted,

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