COMPANY RESPONSE (Cont'd.):

(Birmingham): A warehouse addition and improvements were made to the interior of the administrative facility by Sunlink. The addition consisted of 120,000 square feet of warehouse space plus loading dock and additional paved area. The additions required by BST increased the original cost- per-square-foot of the building by 36%.

(Jacksonville) Prior to July, 1987, 188,274 square feet of space were leased and were billed at approximately $2.00 per square foot. An addition of 97,978 square feet of office and warehouse space was made bringing the total leased space to 286,252 square feet. The additions increased the original cost-per-square-foot of the building by 30%.

These additions and cost-per-square-foot data can be observed easily through review of the C&L workpapers. Also, numerous publications exist to support market rental rates in these areas as well as inflationary trends in the economy. The remaining major incorrect statements are corrected below:

- Contrary to this finding, complete information necessary to evaluate FDC and overhead calculations was provided on numerous occasions. The C&L workpapers contain the complete FDC analysis with all components included. C&L also retains relevant lease documentation in their files. They compute FDC per square foot for the warehouses which was compared to actual lease rates to show that FDC exceeded lease rates in every case through 1991. Abundant evidence to support the pricing of warehouse rentals charged to BST was clearly provided and corporate overhead charges were supported.

- The finding irresponsibly asserts that Sunlink selectively applies FDC pricing. The facts simply do not support such an assertion. In each case, an FDC comparison is made to document that lease rates were below FDC. Using FCC rules, the only option for evaluating pricing of the warehouse transactions with BST has been FDC since Sunlink provides no warehouse leasing to any other customer and thus has no basis for market rate comparisons for this type of property. Since an FDC comparison is typically a more conservative means of evaluating lease rates than market rate comparisons, such a comparison documents the prudency of these leases. The allegation that FDC pricing naturally causes cross-subsidization of properties priced at market is illogical and totally without merit.

- Sunlink's project-based accounting system ensures that every activity or project including the leasing of each property owned by Sunlink (regardless of pricing methodology) receives its appropriate share (i.e.,

COMPANY RESPONSE (Cont'd.):

JCO compliant allocation) of overheads and other corporate costs. This system has been designed in strict compliance with JCO fully distributed costing rules and is used in the evaluation of affiliate leasing transactions.

Clearly, the audit team had available to it sufficient evidence to support Sunlink's JCO compliance and relevant cost data when reviewing the C&L workpapers. In addition, the increase in lease prices per square foot had been specifically explained in response to JWC-16 as well as above. Therefore, the recommendation to exclude lease costs from the rate base, calculate chaining to Georgia, or disallow all costs is contrary to the documented facts and clearly without merit.

FINDING/RECOMMENDATION:

Commercial space which is leased from a nonregulated affiliate for regulated operations should be evaluated to determine if the lease space is actually being utilized.

COMPANY RESPONSE:

As stated in the auditor's report, the vacancy observed at 3700 Colonnade related to reorganizations and expiring leases. The audit team requested no information on this matter during the course of discovery and its finding therefore includes inaccurate and misleading conclusions. This situation was the result of carefully planned and prudent business decisions and the correct statement of facts is detailed below.

The lease for the building located at 3700 Colonnade was executed in June of 1989 for a 10-year primary term. Upon lease approval, the building was at full occupancy. During the last 5 years, the company has undergone considerable restructuring. The most notable effect in Birmingham was the consolidation of Comptrollers during 1992 and 1993. Much of the occupied space in 3700 Colonnade consisted of Comptroller functions which were consolidated to other locations during the second and third quarters of 1993. The vacant space in 3700 Colonnade was held in reserve in anticipation of relocating other functional groups from expiring and less desirable leases in the Birmingham area. This relocation was complete in October and November of 1993. The building has been at or near 100% occupancy levels since that time.

Clearly this finding was based on a lack of understanding of the facts and is wholly without merit. Any additional future requirements would be unnecessary, unduly burdensome and inappropriate.

FINDING/RECOMMENDATION:

Commission should perform regular future audits focused on real estate and lease transactions which involve affiliates in any way. An intrastate adjustment of $321,609 should be made to the Surveillance Report to compensate regulated customers for excessive Chastain Center lease expenses.

COMPANY RESPONSE:

The Company will address the two significant parts to this finding.

1. The analysis of the initial relocation of Engineering, Business, and Forecasting operations and the Outside Plant Control Center (OPCC) from the Whitlock Building to Chastain Center.

2. An analysis of costs and other considerations related to the Whitlock Building.

INITIAL RELOCATION

Commission approval is not needed before the Company leases space from nonregulated affiliates. All real estate decisions are made based upon careful analysis and in-depth economic studies.

The Company decision to move from the Whitlock Building was economically justified based upon two detailed economic analyses. One study was done and provided to the auditors concerning the proposed move of the Engineering, Business, and Forecasting Operations. A second study (also provided to the auditors) was performed concerning the relocation of the OPCC. Both studies were comprehensive and included all relevant information such as present value of the rents, renovations, lease penalties, and utilities.

The first study focused on the Engineering, Business, and Forecasting Operations and it shows that the Company did definitely search and identify alternatives to moving to Chastain. The other alternatives included moving to Whitewater Business Park, moving to Park Square, or remaining at Whitlock. Whitewater was several hundred thousand dollars higher than any of the other alternatives. Park Square was less expensive, but it was not pursued because of concerns that the building might not ever be built and concerns that the actual costs might exceed the estimated costs. (As information, the building has yet to be built). The option of remaining at Whitlock was carefully reviewed, but the Company decided against this alternative based on the economic analysis in conjunction with other considerations (discussed in "Other Considerations for Whitlock" on page 3).

COMPANY RESPONSE (Cont'd.):

The second study analyzed the proposed move of the OPCC. This study considered the alternatives of remaining at Whitlock, moving to Chastain, or moving to another location. When all relevant factors were considered, the study showed that the Company would save $107,018 by moving to Chastain. See "Analysis of Costs" Item (5) for more information.

ANALYSIS OF COSTS

The allegations regarding the $428,812 overcharging of expense are erroneous because the auditors failed to consider all the facts. The Company's decision to move to Chastain was economically justified based upon two detailed economic analyses. At the very most, the additional cost of moving was $321,794 or $241,346 on an intrastate basis. This amount was considered along with the noneconomic factors described under "Other Considerations for Whitlock" in making the decision to move. A summary of the correct costs and a discussion of each of the items is provided below:

	Whitlock	Chastain
Engineering Move		
Company's PV Analysis	$2,633,199	$2,806,461
Items Not Included:		
(1) Common Area		107,849
(2) HVAC Space		39,701
(3) Rental Savings		(32,000)
(4) One Time Charges		140,000
OPCC Move		
(5) Company's PV Analysis	357,163	250,145
Total	$2,990,362	$3,312,156

(1). Common Area Maintenance (CAM) - As stated in the audit report, the CAM costs at Chastain were approximately $1.05 per square foot in 1991. It is probable that the CAM costs at Whitlock would also have been higher than in the study since both buildings are in the same geographic location. In order to be conservative, however, the Company will not dispute this amount.

COMPANY RESPONSE (Cont'd.):

(2). Heating Ventilation Air Conditioning (HVAC) Space -

The increase in costs due to the HVAC was for two mechanical rooms for the Heating Ventilation Air Conditioning (HVAC) system. Furthermore, relocation of the HVAC system inside the building was expected to yield cost reductions and maintenance advantages over roof mounted units. However, the Company will be conservative and not dispute the amount.

(3). Rental Savings

As noted by the auditors, the Company was able to negotiate two month's rental reduction of $32,000 with the owners of the Whitlock Building.

(4). One Time Charge of $140,000

The $140,000 was for technological and architectural changes to the original plans which were likely to have occurred under any of the alternatives. However the Company will be conservative and not dispute the $140,000.

(5). Outside Plant Control Center (OPCC) -

The Company actually saved $107,018 by moving to Chastain. This was based upon a separate economic analysis that was performed regarding the move of the OPCC. The OPCC was not included in the original analysis because the decision to move the OPCC to Chastain had not been made.

The Company's original plans were to move the OPCC from Whitlock to available central office space. However, space requirements for the OPCC increased subsequent to that decision, making it impossible for this function to fit into the available central office space.

OTHER CONSIDERATIONS FOR WHITLOCK

Furthermore, the auditors failed to consider some very important issues associated with the Whitlock Building. These considerations more than offset the relatively small additional costs to move to Chastain. These items are described below:

COMPANY RESPONSE (Cont'd.):

1. There was no expansion room available at Whitlock. As a matter of fact, with implementation of the following year's plans (1989), the Whitlock Building would have been 100% occupied and the Company was going to have to lease an additional 2,471 square feet elsewhere.

2. The owners of the Whitlock Building were unwilling to commit to a lease term longer than 7 1/2 years. The forecasted need for space was for 15+ years.

3. The building was in a deteriorated condition and the present owner was unwilling to spend significant funds for repairs. For example, there were some structural problems with the building and the front entrance and steps were settling. On the other hand, Chastain was a new building.

4. The building had poor heating and cooling.

5. The building was in a very congested area, with poor ingress and egress.

CONCLUSION

Even being extremely conservative, the auditor's alleged additional expenses for the move to Chastain were overstated by at least 25%. Furthermore, the auditors failed to note some very important other issues such as the Company's search for other alternatives, the building condition, and poor response from the landlord.

FINDING/RECOMMENDATION:

The interest received by Southern Bell from advances to affiliates should be offset against book interest in the interest synchronization adjustment.

COMPANY RESPONSE:

The audit report is erroneous in its conclusion that the Company received a cross-subsidy from the interest synchronization adjustment.

Southern Bell made advances to BSS and BSS paid interest to Southern Bell. The audit report notes that "Southern Bell's accounting for the interest on advances was correct." However, the report is incorrect when it concludes that "if the advances had not been made to the nonregulated affiliates, Southern Bell debt could have been substantially lower." This is based upon the erroneous conclusion that the Company had to borrow incremental funds to loan to BSS, resulting in increased Georgia revenue requirements. If SB did not have BSS as a centralized provider of various services, SB would have had to either provide the services internally or use outside suppliers. In either case, SB would have needed to fund the same operations BSS provides. The existence of BSS did not increase the amount of debt SB needed to do business.

The staff's witness in the 1989-90 Rule Nisi hearings (Docket 3905-U) claimed that SB's debt ratio should be higher. It is surprising that the audit team is now recommending a decreased debt ratio for SB.

Even if the Company accepted the fact that eliminating the BSS advances would reduce SB debt, which it does not, this change would not have as much of an impact on the interest synchronization adjustment as the auditors contend. The Company provided information to the auditors to correct their calculations, but it was not used by the auditors.

FINDING/RECOMMENDATION:

The Company achieved a cross-subsidy relating to the Rose CXC PBX. The Commission should increase its audit scrutiny of the Company's CPE-related transactions.

COMPANY RESPONSE:

It is misleading to state that "this transaction resulted in a cross-subsidy from regulated operations to nonregulated operations." In this finding, the auditors have discovered one billing error and nothing else.

This was an isolated incident of a small magnitude. This finding reflects the only instance of not billing an affiliate for asset usage that the auditors found over a discovery period of almost 2 years.

During the audit period, telecommunications equipment used by BSS generally remained on the books of the telco, and the investment was identified for billing to BSS. In this case, the investment for the Rose PBX was in a Southern Bell owned building, and it was not properly identified for billing. However, it should be noted that if asset usage for the Rose PBX had been properly billed to BSS, approximately 55% of the costs would have been return billed to SB.

The report is incorrect in the statement that the Rose PBX "is in the CPE area in which the auditors have identified other cross-subsidies." The Rose PBX was used internally for corporate communications equipment and was entirely unrelated to the BSS CPE inventory which was held for resale.

FINDING/RECOMMENDATION:

Accounting and Information Management costs should be directly assigned whenever possible.

COMPANY RESPONSE:

The Company is in full compliance with the FCC's cost allocation rules in Part 64. The costs associated with the three authority codes in the Incoming Billing Interface Tracking System (IBITS) were corporate expenses related to centralized accounting and information management functions which were common and not directly assignable to either regulated or nonregulated. In addition, all information management expenses (Account 6724) are associated with general purpose computers and cannot be directly assigned based upon the definition of direct assignment.

In the CAM Uniformity Order (AAD 92-42, released July 1, 1993), the FCC clarified the definition of direct assignment as "costs incurred in providing either regulated service exclusively or nonregulated service exclusively". Furthermore, the FCC said "direct assignment of an asset can only occur when an entire asset is used exclusively for regulated activities or when an entire asset is used exclusively for nonregulated activities".

The three accounting and information management projects which were billed to SB from BSS did not meet the criteria for direct assignment. These functions were centralized to provide for multiple departments and business functions. Therefore these expenses cannot be directly assigned to a single business function or line of business. The expenses associated with all three of these projects were directed to the appropriate cost pool based upon the function performed and apportioned to regulated and nonregulated in a cost causative manner based upon the FCC's cost allocation principles.

The inappropriateness of a direct cost pool for BST is relevant to both Account 6124 (General Purpose Computer expense) and Account 6724 (Information Management expense). Part 32 defines information management expenses in Account 6724 as costs "incurred in planning, developing, testing, implementing and maintaining data bases and application systems for general purpose computers." SB's general purpose computers literally perform hundreds of various functions and are not used exclusively for regulated or nonregulated activities. A direct cost pool is not appropriate due to the large volumes of applications and the impracticability of trying to directly assign each of these projects.

COMPANY RESPONSE (Cont'd.):

In summary, information management costs cannot be directly assigned but are appropriately apportioned to regulated and nonregulated in a cost causative manner as per the FCC approved Cost Allocation Manual (CAM).

FINDING/RECOMMENDATION:

BSC International calls should be directly assigned to nonregulated in most cases.

COMPANY RESPONSE:

Again, the auditors simply have missed the essence of the cost allocation process. International calls placed by employees of the international operations of BSC are directly billed to the nonregulated side of the business. When international calls are placed by the staff at BSC, the expenses of the calls follow the expense allocations of the department or group making the calls. That is, long distance charges on BSC's bill become part of departmental overheads and are allocated based upon the individual department's established allocators [as per FCC 64.901 (b)(3)(ii) above] with respect to regulated and nonregulated entities. As a result, international long distance calls have been allocated appropriately to the unregulated functions <u>and</u> in complete compliance with FCC rules.

FINDING/RECOMMENDATION:

A portion of BSC unattributable costs should be retained by BSC.

COMPANY RESPONSE:

As explained to the auditors repeatedly, this finding is incorrect and apparently based on a misunderstanding of definitions contained and explained in response to RBL 57 & 62 and numerous telephone conversations between Snavely & King and BSC subject matter experts. The nature of costs allocated by the BSC General Allocator was never adequately reviewed or understood by the auditors as it does not support the allegations in this finding. The definitions used by BSC in its cost allocation process differ from those used by the telephone companies. The FCC rules were prescribed for carriers and serve as general principles for affiliates. BSC's allocations are done appropriately in accordance with these principles. Indeed, BSC's cost allocation process has been reviewed as part of the annual FCC Cost Allocation Manual (CAM) compliance audits (which have been reviewed by the Georgia PSC Staff Audit Team and Snavely & King). None of these audits has resulted in adverse findings or audit exceptions in this area.

Even if, arguendo, any modifications were appropriate, it should be noted that the inclusion of retained amounts in the basis of calculation of the General Allocator would result in insignificant changes based upon the following facts:

--Response to RBL-57 included workpapers indicating the annual basis of allocation for 1991 was nearly $11 billion.

--Response to RBL-62 (Supplemental) showed total retained amounts of just over $125 million. Of this amount, over 85% was projects billed from subsidiaries and retained at BSC, the cost of which would already have been included in the General Allocator base above, and interest or other non-operating expense.

--A simple calculation following the "logic" of this finding demonstrates its insignificance. If the remaining 15% of the total retained amount (or approximately $18.8M) were added to the allocation base ($11B), it would change it less than two-tenths of one percent. Of the $19.7M referenced in the finding as allocated by the General Allocator in 1991, this would have changed the allocation by less than $35,000, approximately half of which would have been allocated to Southern Bell, approximately 29% of that to Georgia with approximately 70% relating to intrastate operations. This results in a disputed charge of about $3,600.

COMPANY RESPONSE (Cont'd.):

However, as stated above, since BSC's expenses have been appropriately allocated in accordance with FCC rules 32.37 and 64.901, all of these amounts become irrelevant.

FINDING/RECOMMENDATION:

The transactions between BAPCO and SGI should be specifically covered by Rule 32.27(d) for the purposes of the Georgia Surveillance Report. Substantial third party sales should be interpreted to mean that 75 percent or more of the sales are to non-affiliated companies.

COMPANY RESPONSE:

This finding is incorrect and reflects a lack of understanding of the information provided, discussed and reviewed. The finding is based on statements taken out of context in documents relating to other jurisdictions. As noted, there are no existing cost allocation rules from the FCC or in Georgia that apply to transactions between BAPCO and Stevens (SGI). Because the FCC has accepted the negotiated pricing methodology embodied in the publishing fee contract between BAPCO and BST, transactions related to this contractual arrangement between BAPCO and other affiliates are not subject to the pricing hierarchy described in Part 32 of the JCO rules.

However, as also stated, SGI "believes that this [its] market pricing is supportable by the level of non-affiliate business in 1992." The relationship between BAPCO and SGI predated SGI's acquisition by BellSouth. Today's contract reflects, in the aggregate, the same prices as those charged prior to this acquisition. These prices were comparable when set to those charged by SGI to non-affiliate customers. It is therefore clear that these transactions meet any reasonable standard of prudency.

No compelling reason to utilize the proposed methodology has been put forth by the auditors and no benefit would be realized by so doing. Further, their calculations lack factual support and grossly overstate the amount of alleged cross-subsidy under this improper standard. It is totally illogical to assume, without any information on growth trends or prior year's volumes, that an amount estimated for 1992 would apply equally to four previous years.

Furthermore, the recommendation that the concept of substantial third party sales, even though not relevant to anything discussed in this finding, be interpreted to mean that 75% or more of the sales are to non-affiliates is ludicrous. As BellSouth explained in its Comments filed in FCC Docket No. 93-251, for an affiliate (or any other company) to successfully market as

COMPANY RESPONSE (Cont'd.):

much as 25% of its output, it would be highly unlikely that its price exceeded market value for that product or service. Setting the threshold at 75% is an unreasonable and overly burdensome requirement that is unnecessary and completely unwarranted. This issue has not been resolved at the FCC and was strongly opposed in Comments filed by many parties. Holding BellSouth to this standard in one jurisdiction would be extremely burdensome and inappropriate in light of BellSouth's compliance with all existing CAM affiliate transaction rules.

For all of the reasons previously explained and set forth again above, this finding is wholly without merit.

FINDING/RECOMMENDATION:

BellSouth Enterprise's retention of expenses associated with its foreign subsidiaries should be referred to the Internal Revenue Service International Examination Branch and the Georgia Department of Revenue Income Tax Division for further investigation with regard to its tax deductions.

COMPANY RESPONSE:

The auditor is correct in saying that this finding does not have an impact on Georgia's regulated telephone expense allocations. However, the auditor is incorrect in saying that this finding reflects any overstatement of expenses or that there is any impact on the Georgia tax obligation of BellSouth. The auditors have also ignored numerous discussions with the Company and all evidence provided by the Company which indicates that the IRS International Examination Branch routinely conducts a review of the expenses identified in this finding.

As has been explained to the auditors repeatedly, the expenses which have not been billed to the foreign subsidiaries are stewardship expenses which are properly borne by BSE or BSI for U.S. federal income tax purposes. Federal income tax law allows a deduction for parent company expenses not directly connected with a subsidiary's day-to-day operation. See Young & Rubicam Inc. v. United States, 410 F.2d 1233 (Ct. Cl. 1969). Inasmuch as Georgia taxable income is based upon federal taxable income, the expenses are also properly classified for purposes of the Georgia income tax. Furthermore, expenses related to foreign activities have been (for 1988-1989), or are in the process of being (for 1990-1991), reviewed by the Internal Revenue Service International Examination Branch as a routine component of the federal audit of BellSouth's tax returns. Should any adjustment(s) be made as a result of the federal audits, it will be reported to the Georgia Department of Revenue via amended tax return(s).

In addition, most of our investments in foreign utilities are joint ventures. It would have been in BellSouth's best interest to have passed these expenses on to the foreign entities because BellSouth would have only borne its share of those expenses. However, BellSouth feels these expenses are appropriately borne by BSE or BSI as stewardship expenses.