Ideally, a costing process should identify the additional research and development and implementation costs of building a network that can offer enhanced as well as basic services. Aside from any issue of the possible biasing of hardware design to favor nonregulated services, however, the design and costing of the associated software present a greater dilemma. Software development comprises a significant proportion of costs to the LECs of upgrading their networks, but it is often difficult to determine the actual cost of software due to discounting and other pricing practices that effectively bundle software costs with hardware costs. Under these circumstances, if a particular software package is acquired at the time of the initial purchase of a switch that is necessary only for future nonregulated services, it would be virtually impossible to develop a costing model to reflect this underlying factor.

Even if the unbundled cost of software could be determined, the allocation of the cost of most software to individual services is virtually impossible. For example, the basic

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88/ (...continued)
BOCs assume (BOC MFJ Reply at 58; Farmer Reply Aff., BOC MFJ Reply, at 14-15) that network investment is static and that the same facilities that are being jointly used would otherwise have been used only for regulated services. Under that assumption, the nonregulated service users are supposedly subsidizing the regulated service ratepayers by bearing some of the costs that the ratepayers otherwise would have borne entirely. In reality, however, more expensive facilities will be installed if joint use is intended, and the regulated ratepayers will end up bearing a disproportionate share of the additional cost, even though that additional cost was necessitated by anticipated nonregulated usage.

operating software of a digital central office serves many purposes, and it cannot be attributed solely either to regulated or nonregulated services. Moreover, even directly allocating the cost of specific applications software developed for nonregulated services to those services will not reflect the changes in operating system software or data base management system software that may be necessitated by the new applications software. In sum, standardization of allocation models will not solve the joint use cost issues because there is no way to design the key element of such a model -- an allocator that accurately distinguishes between regulated and nonregulated costs. The more facilities that are jointly used for both regulated and enhanced services, the worse this problem will become.

b. The Commission's Cost Allocation Rules Are Ineffective When the BOCs Retain Control Over Both the Allocation Formula and the Internal Data Used to Apportion Joint Use Costs

As long as a carrier's judgment is so crucial to the costing process, the carrier cannot be held accountable to any objective standard. The discretion of the BOCs to both design the costing paradigm and input the data maximizes opportunities to direct the results of their usage allocations. Eliminating design flexibility (e.g., standardizing the allocation manuals) may reduce the problem, but no degree of monitoring (e.g., independent audits) or controls (e.g., the benchmark ratios of ARMIS) can remove the underlying incentive of the BOCs to cross-subsidize nonregulated services with regulated profits. As long as this incentive exists, opportunities for the LECs to thwart the Commission's objectives will remain.

The costing safeguards that the Commission offers as a solution to this problem primarily serve as cost misallocation "detection devices," which function most effectively when applied to transactions that take place on an arm's-length basis. The rules governing transactions between affiliates establish explicit standards for exchanges between two discrete business entities, and carriers that fail to comply with these rules can, on occasion, be identified through the audit process. The current and proposed cost allocation rules, on the other hand, are not so clear, and it is more difficult to detect breaches of those rules (even with stricter audit standards), because they are ambiguous and subject to inconsistent carrier interpretation.

The relative effectiveness of the Commission's rules when applied to affiliate transactions is illustrated by an audit of BellSouth's Cost Allocation Manual conducted by the Southern Task Force, a staff committee of the Southeastern Association of Regulatory Utility Commissions (SEARUC). The Audit Team reported that it believes that BellSouth's Cost Allocation Manual was "inconsistent with the requirements of Section 32.27(d) of the Uniform System of Accounts."89/ It reached this conclusion because BellSouth apparently improperly recorded on the books of

89/ SEARUC Southern Task Force BellSouth Audit at EX-7.

the regulated operating companies an affiliate transaction at a "negotiated contract" rate in excess of the actual cost of the service, resulting in a total overstatement of regulated costs by $400 million since divestiture.[90]

Further, in an order adopted on October 3, 1990, the Commission accepted the Consent Decree negotiated in response to the NYNEX Telephone Companies' apparent violations of Commission rules governing affiliate transactions between the operating companies and NYNEX Material Enterprises Co. ("MECO").[91] Under the terms of the decree, NYNEX was required to reduce its interstate rates by $35.5 million, reduce its capital accounts by $32.6 million, adjust its 1990 Form M reports, and voluntarily contribute $1.419 million to the U.S. Treasury. As is shown by these examples, when carriers engage in flagrant violations of simple, clear rules, such as the affiliate transaction rules, it is far easier to take corrective action and assess penalties of the magnitude necessary to deter subsequent transgressions, than is the case when the infraction is of a more ambiguous nature.[92]

90/ Id. at EX-8.

91/ New York Telephone Co. and New England Tel. & Tel. Co., FCC 90-328 (released Oct. 4, 1990).

92/ Moreover, the relatively flagrant violations involving MECO were going on for a number of years, and were uncovered by private whistleblowers rather than the Commission's own investigation (see Boston Globe, December 22, 1988, at 1; MIS Week, January 9, 1989, at 7-8). The MECO Consent Decree thus (continued...)

The value of these rules and monitoring procedures is significantly reduced if the Commission fails to require structural separation of BOC regulated and enhanced service operations. Reliance upon a carrier's cost allocation manual to eliminate cross-subsidization is a particularly ineffective and inadequate solution when it is applied to the carrier's integrated operation because it is based predominately on judgment calls (both in designing the model and in evaluating the functional characteristics of the input cost data) and not on explicit, simple rules. It is difficult to identify, substantiate, and assess penalties for those rule infractions which fall into the "grey areas" that are endemic to both the development and application of carriers' cost allocation manuals.

An example of the problems associated with a system based on judgment involves the time reporting of a technician who both installs telephone lines (regulated) and repairs inside wiring (nonregulated). Only the individual performing the work function can attest to the correct allocation of the work effort. Even if the person is not aware of the financial impact of over-reporting regulated time, management may have provided subtle encouragement which might give the technician an incentive to incorrectly report the time required to perform the regulated task. Or, it

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[92](...continued)
hardly gives ratepayers a great deal of confidence that they will be protected, even where violations are relatively easy to detect.

simply may not be apparent to an individual how to appropriately allocate time. This could occur in an external relations function, where it might never be known whether the regulated or nonregulated sector benefitted from a particular encounter.

When these types of misallocations occur, there is little opportunity to detect or verify their existence, and therefore, it is unlikely the Commission will take punitive action against the carrier. It is next to impossible to judge the accuracy of an individual's time reporting, short of assigning another person full time to verify all reported activities, an impracticable and still judgment-based means of attempting to curb cross-subsidization. Further, even if a discrepancy were discovered, it is not likely to be an egregious rule violation, but rather a misinterpretation or "bending" of the rules.

c. The BOCs Will Continue to Overproject Their Regulated Use of Joint Investment and Expenses, Rendering Incorrect Any Forward-Based Allocation

The Commission should also retain its structural separation requirement because of the burden imposed on ratepayers due to the inaccuracies inherent in carrier forecasting of the relative regulated and nonregulated use of shared network facilities and resources. Even under price cap regulation, it is still in the BOCs' financial interest to overallocate costs to regulated operations because of the "sharing" obligation, as noted earlier. If a carrier overestimates regulated usage, it is required to transfer the excess amount of investment from the regulated to the nonregulated books of account at the authorized interstate rate of return. If a carrier underallocates its regulated costs, on the other hand, no such adjustment mechanism exists. Once a carrier allocates costs to its nonregulated operation, therefore, it runs the risk of lower profitability, should nonregulated demand fail to materialize.

To avoid such an outcome, a carrier may choose to simply overforecast regulated usage, and later, if necessary, make the penalty-free adjustment. The resulting overassignment of costs to the regulated side reduces the carrier's price cap sharing obligation, thus ultimately forcing regulated ratepayers to finance investment that actually benefits nonregulated services.[23/]

Thus, overall, the BOCs retain the flexibility to free their nonregulated services of any of the normal business risks of making long term competitive investments. If a BOC were to overinvest in facilities used partly for competitive services, or if demand for a competitive service fails to materialize, these BOC operations do not face risks commensurate with those encountered by similar non-BOC affiliated ventures. To the

23/ Similarly, if a carrier were struggling to achieve a minimal earned return, it might be encouraged to load costs onto regulated services because the lower adjustment formula mark guarantees a level of profitability that is not guaranteed for competitive services.

extent that such investments can be allocated to regulated services, the nonregulated business unit is not burdened with the total risk associated with that investment. Structural separation must be maintained to reduce the ratepayers' exposure to the financial burden and risks associated with incorrectly allocated unregulated costs.[94/]

[94/] The BOCs may argue that the exogenous treatment of reallocations from regulated to nonregulated costs under price caps (see LEC Price Cap Order at ¶¶ 171-72) will serve as an effective check on the tendency to overallocate costs to regulated services. At first glance, the "penalty," in the form of a PCI reduction, of having to correct for such overallocations under price caps would appear to deter such overallocations.

In fact, however, the forecasting methods used by the BOCs continue to provide loopholes which a creative BOC will be able to use to ensure that such a costly reallocation can be avoided through adept forecasting. As BOCs make new investments, annual forecasts of relative use are made to add these investments to the existing cost pools. At the end of each year, forecasted use is compared to actual use for each pool. On a going-forward basis, the forecasted usage for the cost pool equals the weighted sum of the forecasts for each year's addition to the pool. At no point, however, is any forecast of the usage of a single year's investment compared to the actual usage of that particular investment. Rather, the comparisons are made between usage and projections for all investments added to the cost pool from the time the nonregulated services are first offered until an investment is fully depreciated. Accurate forecasting, therefore, is never required on an individual investment basis, creating an opportunity for the BOCs to adjust for previous forecasts instead of making downward rate adjustments.

As long as relative use projections are adjusted every year, as new investments are added to the pool, BOCs can always skew usage projections for new investments to offset previous regulated overforecasting. Thus, as actual regulated usage of existing investment falls short of previous projections, the regulated usage of new investment can be similarly overprojected so that overall, projected regulated usage appears to be in line with actual regulated usage, thereby avoiding the need for reallocation from regulated to nonregulated costs.

d. Joint Cost Rules Cannot Prevent Misallocations of Personnel Costs

Joint cost rules are also useless in allocating one of the most important investments in the information industry, namely human costs. Nothing in the Commission's joint cost rules, or in any conceivable set of rules, can control the inherent subsidizing of enhanced services that occurs when regulated service employees develop a network capability that will be useful for the BOC's enhanced services, especially one that will not be as useful for other ESPs' services. The network capability and the BOC employees are part of the regulated system, so their costs are attributed entirely to regulated services. In fact, however, it is the enhanced services that have benefitted, while bearing none of those costs. An even more obvious, but still unrecognized, cross-subsidy occurs when an employee is trained by a BOC and then transferred to the enhanced service operations. His or her salary and other overhead expenses may be attributed to the enhanced services from then on, but the value of the training invested by the ratepayers is never recaptured.[25/]

3. Cost Accounting Regulation Operates Only After the Fact

In those limited situations where cost accounting regulation might work, it still fails because it operates only after the

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25/ Such transfers can still take place under structural separation, but they at least are more visible in that case.

fact. Until the time that the Commission's overstrained audit resources can be brought to bear on a cost violation, the BOC is able to overcharge its regulated ratepayers and undercharge its enhanced service customers. It can thus unfairly gain market share at the expense of independent, lower-cost ESPs, thereby possibily damaging competition in enhanced services. Once the Commission catches up with the violator, the economic damage has been done and may not be remediable. Even with the increased penalties described in footnote 61 of the NPRM, a BOC will still have an economic incentive to misallocate costs. The penalties, if they are assessed, are still trivial compared with the tremendous multi-million dollar advantages that can be secured through cost misallocations of only hundredths of one percent of total costs. Penalties are still just another cost of doing business for the BOCs, leaving their incentives to shift costs and cross-subsidize unaffected.

4. The Five Proposals in the NPRM Add Nothing of Significance to This Proceeding

Finally, the five new proposals in the NPRM -- although positive steps in themselves -- must be discounted in any cost-benefit analysis of the substitutability of nonstructural regulations for structural separation. The first proposal is nothing new, but rather calls for continued nonregulated treatment for enhanced services.[96] Obviously, any joint cost

[96] NPRM at ¶ 27.