> to the economic costs associated with the replacement of current switches that a modular network would seem to require, we must address problems that may arise with increased access by network users to switches. It is vital to the public interest to protect the reliability and integrity of our telecommunications networks. For this reason, it will be important to evaluate whether future network technologies the promise wider network user access can provide sufficient network reliability, and at what costs. Therefore, we seek comment on whether the potential benefits of increased access by network users in a modular architecture outweigh any costs.[185]

Hatfield states that the BOCs "oppose mediated access to the AIN in any form...."[186] ITAA states that "the BOCs' reactions to the Commission's proposals have ranged from lukewarm to outright hostile," and states that we have expressed reservations about the cost of mediated access and claimed that "mediated access to the switch would present major network reliability problems...."[187] ITAA also expresses concern regarding whether or not the BOCs' enhanced service operations will access intelligent network functions through the same type of mediated access as unaffiliated ESPs.[188]

Hatfield is wrong. The BOCs do not oppose all forms of mediated access to AIN. We, for instance, have proposed a reasonable form of mediated access that would avoid the serious technical problems of the mediated access proposed by the Commission, while still meeting the Commission's goals.[189] In response to ITAA's

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185 Intelligent Networks, CC Docket No. 91-346, Notice of Inquiry, 6 FCC Rcd 7256, 7259 (1991).

186 Hatfield, p. 16.

187 ITAA, p. 36, n. 76.

188 Id. at 36.

189 See Pacific Bell and Nevada Bell, pp. 66-69.

question, under our proposal, our enhanced service operation would take the same access to AIN as all other ESPs.[190]

We could implement our proposal in 12 months. NAA asserts, however, that IN benefits that are at least one year away cannot be considered by the Commission in its determination on structural relief.[191] That assertion makes no sense. Under NAA's snapshot view of ONA, the Commission might make one determination on structural relief now and a different one a year from now. That approach would be completely impractical since the BOCs could not possibly be efficient providers if they were to move back and forth between integration and structural separation.

Hatfield also inexplicably ignores the competition that BOCs face from other providers of intelligent networks.[192] This competition ensures that ESPs can obtain IN services that are economic and technically feasible and gives the BOCs the full incentive to develop IN services in order to retain customers. Thus, with or without a decision on mediated access, the Commission should reestablish structural relief and allow consumers to continue to obtain the benefits of BOC integration.

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190 See id. at 67.
191 NAA, p. 16.
192 See id. at 58-61.

VIII. THE ACCOUNTING SAFEGUARDS ARE EFFECTIVE

A. Cost Allocations Rules Deter And Detect Improper Cross-Subsidy

Opponents of structural relief continue to criticize the Commission's accounting safeguards, without saying anything new about them.[193] The accounting safeguards themselves are no longer at issue. In California I, the Ninth Circuit found that the Commission had not adequately explained why accounting safeguards were adequate to support structural relief. In the Computer III Remand Proceedings, after reviewing the extensive record, the Commission explained why they were adequate and strengthened them. In California III, the Ninth Circuit found that the Commission adequately explained why its strengthened accounting rules would protect against cross-subsidy.[194] Thus, the Court's California III Opinion did not require that the Commission reconsider the accounting safeguards on further remand. Although the Commission requested comments on issues beyond those raised by the Court, the Commission did not request comments on the accounting safeguards.

In so far as the accounting safeguards are a part of the Commission's cost-benefit analysis for removal of structural separation requirements, they strongly support removal because they provide one of the key benefits that structural separation was originally intended to produce -- protection against cross-subsidy -- whether the BOC integrates or separates its enhanced service operation. None of the comments by opponents of structural relief weaken this support.

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[193] MCI, p. 45; Hatfield, p. 43; ITAA, p. 56; IIA, p. 2.
[194] California v. FCC, 39 F.3d 919, 926, (9th Cir. 1994).

MCI asserts that "cost allocation rules are inherently ineffective," and that "there is no accurate allocator for jointly used resources."[195] MCI provides examples of disputes that it asserts support its argument, but we have shown above in Part V that its examples are either irrelevant or immaterial to this proceeding.

Hatfield merely speculates as to why accounting safeguards may not be beneficial "if there are no real economies of scope from joint provision of regulated and unregulated services, and if the telephone company has selected a technology with high common costs."[196] Hatfield's speculation that there may be no scope efficiencies is without merit. In Computer III, the FCC allowed the BOCs to offer enhanced services without structural separation because it found that the benefits of separation are outweighed by the costs of lost scope efficiencies.[197] Regardless of the technology involved, joint provision produces substantial efficiencies by allowing the sharing of administrative and support functions, such as joint marketing, joint installation and maintenance, joint use of office space and overhead staff (e.g., legal and accounting), joint financing, and common officers.

ITAA asserts that "monitoring transactions between affiliates is substantially less burdensome than reviewing millions of daily transactions between a carrier's regulated and unregulated integrated operations."[198] ITAA does not provide

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195 MCI, p. 45.

196 Hatfield, p. 43.

197 E.g., Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), Report and Order, 104 FCC 2d 958, at paras. 18, 91, (1986); Bell Operating Companies' Joint Petition for Waiver of Computer II Rules, Memorandum Opinion and Order, at paras. 4, 6-7 (released July 23, 1990).

198 ITAA, p. 56.

any support for its hyperbole concerning the number of transactions and does not acknowledge how either the Commission's affiliate transaction or joint cost accounting safeguards operate. As discussed below, because of these safeguards the ability of auditors or regulators to establish whether or not the BOC is avoiding cross-subsidy is unaffected by whether the BOC offers enhanced services on a fully integrated basis or in a subsidiary that has transactions with the BOC.

Finally, IIA does not provide any support for its assertion that "[o]nly structural separation can eliminate the risk of sharing between regulated and unregulated activities and the opportunity for intentional or inadvertent cost manipulation."[199] Removal of the structural separation requirements does not require a Commission finding of an elimination of risk, but rather a finding that the costs of structural separation outweigh its benefits. The record shows that they do. The best means for preventing cross-subsidization are the Commission's rules contained in the Joint Cost Order, which are applied to both integrated and separate operations, and the Commission's audit requirements that detect cross-subsidies of unregulated services.

The Joint Cost Proceeding

The opponents of structural relief ignore the Commission's experience in developing and applying accounting safeguards that work. The extensive record in the Joint Cost Proceeding, which was not before the Ninth Circuit in California I, provided

[199] IIA, p. 2.

the Commission with what it needed to create specific accounting treatment as an effective safeguard against potential BOC cross-subsidization of enhanced services.[200]

The Joint Cost Order established a cost allocation method that deters cost shifting by either misallocation of joint and common costs[201] or improper intracorporate transfer pricing.[202] Where costs are not directly or indirectly identified as regulated or nonregulated, costs are treated as "residual" and allocated on the basis of a ratio of regulated to nonregulated costs. Where transfers occur between a regulated carrier's regulated and nonregulated accounts or between a carrier and its nonregulated affiliate, the ratepayer is favored over the nonregulated business in order to ensure that ratepayers are charged only just and reasonable rates.[203]

The Commission also prescribed detailed accounting procedures for both regulated and nonregulated activities of carriers[204] and required the BOCs, other Tier 1 local exchange carriers, and AT&T to file cost allocation manuals to implement the new

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[200] The Joint Cost Proceeding was totally separate from Computer III and was affirmed on appeal. Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, Report and Order, 2 FCC Rcd 1298 (1987) (Joint Cost Order); modified on recon., 2 FCC Rcd 6283 (1987); further recon., 3 FCC Rcd 6701 (1988), affirmed sub nom. Southwestern Bell Corporation v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

[201] 47 C.F.R. §64.901.

[202] 47 C.F.R. §32.27.

[203] See 47 C.F.R. §32.27(b) & (c). In Southwestern Bell Corporation v. FCC, supra. at 1381, the D.C. Circuit found that this treatment is a reasonable means of attempting to minimize the risk of cost misallocation. The Joint Cost Order, para. 298, clarifies that the transfer rule applies to all transfers between the regulated entity's regulated and nonregulated accounts, as well as to transfers between separate companies.

[204] 47 C.F.R. §§32.14, 32.23.

regulations.[205] Moreover, the Commission established an annual independent audit requirement for all carriers that are required to file cost allocation manuals.[206]

In the Joint Cost Order, the Commission concluded that its accounting safeguards would prevent cross-subsidies of nonregulated services.[207] In fact, the Commission acknowledged that its joint cost allocation rules can overassign costs to enhanced services, when viewed strictly from the perspective of prevention of cross-subsidy.[208] That is, the BOCs' enhanced services are assigned not only their full direct costs, but also a portion of the joint and common costs that would be borne entirely by regulated services if the BOCs did not offer the enhanced services. Therefore, ratepayers of basic network services pay lower prices, not higher, as the result of BOC integrated offerings of enhanced services.

Whether a BOC offers enhanced services directly or in a subsidiary that interacts with the BOC, the ability of auditors or regulators to establish whether or not the BOC is avoiding cross-subsidy is unaffected -- the difference does not make this task any harder or any easier. When enhanced services are provided as an integrated offering, cost allocation rules guard against cross subsidy. When enhanced services are offered in

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[205] See Joint Cost Order at 1328, paras. 233 and 236. Since 1988, the Commission has required the BOCs (and other large local exchange carriers) to file specific information on their accounts in a standard ASCII format on floppy disks. See Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies (Parts 31, 43, 67 & 69 of the FCC's Rules), 2 FCC Rcd 5770 (1987), recon. granted in part & denied in part, 3 FCC Rcd 6375 (1988) (ARMIS Order). Requiring computerized records to be filed in a common format helps the Commission monitor compliance by individual companies and compare different companies' filings.

[206] Joint Cost Order at 1330, para. 255.

[207] Id. at 1307.

[208] Id. at 1312.

a subsidiary, the Joint Cost Order's affiliate transaction valuation rules apply to interactions between the regulated BOC and its unregulated subsidiary. Compliance with both sets of rules is audited in the annual attestation audit. Thus, the combined joint cost allocation and affiliate transaction rules protect customers of regulated services from cross-subsidization, regardless of how a BOC might choose to provide its services.

Based on the accounting safeguards that were being finalized in the Joint Cost Proceeding, the Commission allowed the BOCs relief from structural separation requirements for the provision of CPE:

> Indeed, our experience with cost allocation and other accounting requirements, as applied to the ITCs and AT&T and in various waivers of the structural separation requirements, coupled with the extensive and detailed record compiled in the Joint Cost Proceeding, leads us to conclude that the regulatory issues concerning cross-subsidization can be addressed adequately through cost allocation and other accounting requirements.[209]

Moreover, on appeal of the Joint Cost Order, the D.C. Circuit concluded that "the FCC [had] adopted measures reasonably designed to prevent systematic abuse of ratepayers."[210]

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[209] Furnishing of Customer Premises Equipment by the Bell Operating Telephone Companies and the Independent Telephone Companies, CC Docket 86-79, Report and Order, 2 FCC Rcd 143, para. 27 (1987) ("BOC CPE Relief Order"); Memorandum Opinion And Order On Reconsideration, 3 FCC Rcd 22 (1987) ("BOC CPE Relief Reconsideration Order"); Order, 64 Rad. Reg. 2d (P&F) 1546 (1988) ("BOC CPE Plans Amendment Order").

[210] Southwestern Bell Corp. v. FCC. supra. at p. 1379.

B. Price Cap Regulation Substantially Reduces Or Removes Any Incentive For Cross-Subsidy

Hatfield states that "[i]n practice, incentive regulation does not eliminate BOC incentive or ability to cross-subsidize competitive services."[211] He states that sharing mechanisms retain some incentive.[212] ITAA and MCI make the same argument.[213]

These parties do not, and cannot, deny that price cap incentive regulation substantially reduces the incentive for cross-subsidy because, even with sharing, price cap regulation largely divorces pricing from earnings. In addition, the Commission has now allowed Tier 1 LECs to choose a "no sharing" option. We and most other BOCs have done so, clearly eliminating any incentive to cross-subsidize.

Thus, the substantial reduction of any incentive to cross-subsidize that resulted from the Commission's original adoption of price cap regulation has been added to the Commission's accounting safeguards that deter and detect cross-subsidy, and that were strengthened in the Computer III Remand Proceeding. Now, added to all that protection is the complete elimination for most BOCs of any incentive to cross-subsidize, because of the "no sharing" option. More than ever before, cross-subsidy is not a barrier to the Commission's granting of structural relief.

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211 Hatfield, p. 38.

212 Id. at 39.

213 ITAA, p. 10; MCI, p. 47.

C. State Regulation Protects Against Cross-Subsidy

MCI asserts that structural relief will deprive both intrastate ratepayers and users of intrastate enhanced services of protections because "the Commission has no plans or intent to force all the states to establish intrastate cost accounting, affiliate transaction and ONA-type regulatory controls as ostensible substitutes for structural separation...."[214] This argument has no merit.

We have shown above in Part VIII that the Commission based its original grant of structural relief on tariff standards that BOCs had to meet for both interstate and intrastate ONA services. Similarly, the Commission has had a tremendous effect on state accounting practices related to non-regulated services. First, the Commission establishes the framework by separating regulated and non-regulated costs under Part 64 of its Rules prior to jurisdictional separations under Part 36. In addition, almost every state regulatory commission utilizes the Commission's Uniform System of Accounts, joint cost allocations, and jurisdictional separations rules as the starting point for its own ratemaking process. For instance, California adopted the Commission's Part 64 rules. Even for states that adopt their own rules, the practice has been to modify the Commission's model. Moreover, a common feature in many states, including California and Nevada, is incentive regulation of prices of regulated services, which substantially reduces or removes the incentive for cross-subsidy.

The states also receive substantial assistance from the Commission and from other states. Since 1990, the FCC has shared computerized BOC accounting data

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[214] MCI, p. 27.

with the states, permitting states to compare cost allocations across time and across BOCs. Since 1987, the National Association of Regulatory Utility Commissions ("NARUC") Regional Oversight Committees have worked together to "ensure effective monitoring of [BOC] activities, to coordinate the sharing of information, to create an adequate database, and to assist the formation of state regulatory policy."[215] State Commissioners meet formally to address common issues, and individual state Commissioners maintain informal contacts, enabling them to compare BOC performance and enforcement issues.

In this environment, there is no reason to believe that the states cannot protect ratepayers and competition. The Commission should reject MCI's argument.

D. The 1993 GAO Report On The Commission's Auditing Resources Should Not Affect Its Decision On Structural Relief

Compuserve, Hatfield, ITAA, and MCI assert that the GAO's February 1993 Report to Congressional Requesters[216] shows that the Commission does not have adequate auditing resources to enforce non-structural accounting safeguards.[217] This assertion is without merit for numerous reasons.

First, as discussed in Section A above, because of the Commission's affiliate transaction and joint cost accounting safeguards, the ability of regulators to

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215 NARUC Bulletin No. 10-1987, Resolution to Establish Regional Oversight Committees for Monitoring the Regional Holding Companies, 7-8 (February 26, 1987).

216 Compuserve, p. 35; Hatfield, p. 47; ITAA, p. 39, MCI, p. 48.

217 Telecommunications -- FCC's Oversight Efforts to Control Cross-Subsidization ("1993 GAO Report").

establish whether or not a BOC is avoiding cross-subsidy is unaffected by whether the BOC offers enhanced services on a fully integrated basis or in a subsidiary that has transactions with the BOC.[218] Since the burden is the same with either alternative, the level of Commission resources should not affect the Commission's cost-benefit analysis.

Second, the GAO acknowledges that it did not consider the impact of price cap regulation, in place since 1991, on the potential for cross-subsidization.[219] As discussed above in Section B, price cap regulation substantially reduces or removes the underlying incentive for cross-subsidization since price ceilings are set independently of the BOCs' earnings and costs. Thus, there is a substantially reduced or removed need for the Commission to be concerned about cross-subsidy, and this factor alone destroys the arguments of Compuserve, Hatfield, ITAA, and MCI that the Commission lacks sufficient resources. In addition, price cap regulation will, over time, reduce administrative burdens on the Commission and, thus, free up resources for other purposes, including auditing.[220]

Third, the Commission has conducted numerous audits of us and other BOCs. In addition, outside accounting firms conduct annual cost allocation procedure audits, which the Commission reviews. GAO's report shows that the Commission was intensifying its efforts to review the independent CPA workpapers. For the three years prior to fiscal year 1991, the Commission reviewed 74 percent of CPA audits completed

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[218] Even ITAA recognizes that under structural separation there would be "transactions between affiliates." ITAA, p. 68.

[219] 1993 GAO Report, p. 27.

[220] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, para. 37 (1990).

(43 out of 58).[221] For fiscal year 1991, the Commission had completed reviews of 85 percent (17 out of 20) and started work on the other three.[222]

Fourth, state public utilities commissions -- which have jurisdiction over 80 percent of our revenues -- conduct regular audits. Moreover, as discussed above in Section C, the Commission has had a tremendous effect on state accounting practices related to non-regulated services.

Fifth, development of specific audit requirements has been an evolutionary process. The GAO observes that the Commission provides additional guidance as the process evolves.[223]

Sixth, ARMIS data reports permit the Commission to identify areas for further review.[224] Also, the GAO observes that the FCC was studying ways to make the data more uniform.[225]

Seventh, the GAO's conclusion is that the Commission should increase its auditing staff and budget.[226] Its report does not fault the Commission's non-structural safeguards, nor its procedures and methods for detecting cross-subsidy.

For all these reasons, the Commission should give no weight to the arguments of opponents of structural relief concerning the accounting safeguards. That this key argument of these parties is worthless weighs heavily in favor of the granting of structural relief. There are no costs of integration that can possibly outweigh the

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221 1993 GAO Report, p. 10.
222 Id. at 11.
223 Id. at 8.
224 Id. at 11.
225 Id.
226 Id. at 2, 3, 13.

substantial efficiency benefits of integration which are bringing new services and lower prices to consumers and are stimulating the growth of new jobs and our national economy.

X. CONCLUSION

For the above reasons, the Commission should reject the arguments of the opponents of BOC structural relief, reaffirm its Computer III policy, and grant the BOCs full structural relief.

Respectfully submitted,

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Date: May 19, 1995
0113298.01

Exhibit A

The page that follows is the signature and notary page that belongs with the report that was attached as Exhibit A to the Comments of Pacific Bell and Nevada Bell On The Notice Of Proposed Rulemaking in this proceeding.

We the undersigned have personally prepared the accompanying report, "Benefits and Costs of Vertical Integration of Basic and Enhanced Telecommunications Services." All of the statements contained therein are true and correct to the best of our knowledge and belief.

J. A. Hausman

Jerry A. Hausman

Timothy J. Tardiff

Timothy J. Tardiff

Sworn to and signed before me this 17th day of April, 1995.

Laura Sawicki

Notary Public

My Commission expires: July 3, 1998