



# Audit Report

SOUTHERN BELL TELEPHONE &  
TELEGRAPH COMPANY

COST ALLOCATIONS  
(REGULATED/NONREGULATED)

AND

AFFILIATED TRANSACTIONS

SEPTEMBER 1994

Utilities Division  
Georgia Public Service Commission  
and  
Snively, King & Associates, Inc.

## I. SUMMARY

The primary objective of this audit was to review the relationship between the Company's regulated telephone operations and both its nonregulated activities and the nonregulated operations of its affiliates in order to learn whether Southern Bell's regulated customers are protected from cross-subsidy. Regardless of whether a practice was sanctioned by any particular rule, standard, or procedure, if the practice resulted in a cross-subsidy the auditors were obligated to identify it as such. For example, the Company achieves a significant cross-subsidy in the income tax area which is not precluded by any particular rule.

This audit required the recognition of numerous regulatory and policy issues in addition to accounting matters. It required analyses of the applicable regulatory policies developed in Commission Dockets 3905-U, 3987-U and 4000-U and FCC Docket 86-111 that deal with cost allocation standards, affiliate transactions and related accounting. The audit also required analyses of the purposes and effects of Southern Bell's actions, plus the reasoning that was used to apply the underlying policies in light of those purposes and effects. From the auditors' perspective, these requirements and reasoning were applied within constraints imposed by proprietary agreements and the inability to examine certain material.

As summarized below the auditors identified a number of specific cross-subsidies and cost shifts. The elimination of these

cross-subsidies and cost shifts appears to have taken on considerable urgency in light of Southern Bell's efforts to advance legislative and regulatory plans that would declare all existing rates just and reasonable and apparently eliminate any regulatory oversight of costs.

This report is divided into five parts. This Summary is Part I; Part II relates to the history of Commission activity in the area of cost allocations and affiliate transactions. Part III contains detailed discussion of the auditors' twenty-seven findings categorized into five issue areas -- tax allocation, MemoryCall<sup>2</sup>, purchasing, cost allocations and affiliate transactions.

#### Tax Allocation

Finding Nos. 1 through 7 and 27 deal with the Company's allocation of tax benefits. The auditors found that many of these benefits result in cross-subsidies from regulated operations to nonregulated services and from Southern Bell to BellSouth affiliates. The auditors offer recommendations that will provide a fair and equitable sharing of these tax benefits.

#### MemoryCall<sup>2</sup>

Finding Nos. 8 through 10 deal with the Company's provision of MemoryCall<sup>2</sup> service. During the course of the audit it became clear that the Company's construction program should be regularly audited for proper assignment between regulated and nonregulated

activities and that Right-to-Use fees should be directly assigned whenever possible.

In June, 1991 the Company began to add MemoryCall<sup>4</sup> costs to regulated operations in the Georgia Surveillance Report. It did not identify these costs in the Surveillance Report and it provided no official notification, tariffs or cost support. The auditors recommend the Company be reprimanded for these failures.

#### Purchasing, Warehousing and Transfers

Finding Nos. 11 through 13 address purchasing, warehousing and transfers. Two primary issues emerged: (1) cost shifts from competitive to noncompetitive services and (2) a cross-subsidy of nonregulated customer premises equipment ("CPE") by regulated operations. The cost shifts from competitive to noncompetitive services are related to a 1990 switch price restructure negotiated between Southern Bell and AT&T which appears to have inflated noncompetitive service costs and reduced competitive service costs. The auditors recommend that the Commission investigate the implications and effects of this price restructure.

The cross-subsidy of nonregulated CPE by regulated operations resulted from the inclusion of unprofitable CPE in BellSouth Services's ("BSS") operations and the consequent inclusion of those results in regulated operations in the Company's Surveillance Report. The auditors recommend a rate base deduction. The Company should also be reprimanded for its failure to inform the Commission

that the BSS add-back included unprofitable, obsolete, nonregulated business CPE.

#### Cost Allocation

Finding Nos. 15 and 16 deal with cost allocations between regulated and nonregulated services. The auditors found the Company generally to be in compliance with Part 64 of the FCC rules. However, assuming continued regulatory oversight of the Company's costs, audit scrutiny of these cost allocations will become more critical as the Company's nonregulated operations increase. The auditors recommend the use of positive time reporting for BellSouth's and Southern Bell's Legal Departments to ensure that each individual is held more directly accountable for how his or her time is charged.

#### Affiliate Transactions

Finding Nos. 17 to 27 identify several issues and cross-subsidies in connection with affiliate transaction rules and cost allocation standards. The auditors recommend increased scrutiny of affiliated lease transactions (Finding Nos. 17 to 20). The auditors also recommend an adjustment to the Surveillance Report interest synchronization adjustment to reflect interest received from advances to affiliates (Finding No. 21). Finding No. 22 recommends that the Commission increase its audit scrutiny of the Company's CPE-related transactions, and is particularly relevant in light of Finding Nos. 3 and 12. Finding Nos. 23 to 26 recommend

specific cost allocation procedures. Of particular significance is the recommendation to define "substantial third party sales" as meaning that 75 percent or more of the sales are to non-affiliated companies.

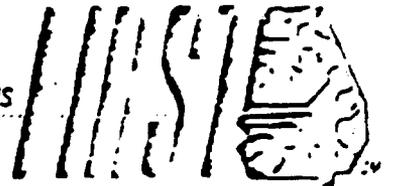
Finding No. 27 deals with affiliated transactions between nonregulated domestic and foreign affiliates. It recommends referral of this finding to the IRS International Examination Branch and the Georgia Department of Revenue Income Tax Division for further investigation.

Finally, Finding No. 14 explains why Southern Bell's recent legislative and regulatory initiatives increase the urgency of eliminating subsidies found in this audit.



**GEORGIANS**

*FORGING AN INFORMATION ROUTE THROUGH STATEWIDE TELECOMMUNICATIONS*



**A Proposal By  
BellSouth Telecommunications, Inc.  
June 22, 1994**

**Georgians FIRST**

**A Georgia Price Regulation Proposal**

**I. PREFACE**

On the effective date of this plan, BellSouth Telecommunications, Inc. (Southern Bell) shall be subject to a price regulation plan in Georgia. The elements of the plan shall be as set forth in detail in the following paragraphs and sections.

**II. DEFINITIONS**

(a) **Basic Services**: Basic Services are those services required to provide flat rate basic local exchange service to residential and single-line business customers. Basic local exchange service means the service comprised of an access line and dial tone provided to the premises of these customers for the transmission of two-way interactive switched voice grade communication for usage within the subscriber's local calling area. (See Appendix A Attachment, para. 1).

(b) **Commission**: The Georgia Public Service Commission.

(c) **Interconnection Services**: Interconnection Services are those services which provide access to Southern Bell's local exchange or toll network for the purpose of enabling another telecommunications provider to originate or terminate telecommunications services. (See Appendix A Attachment, para. 2).

(d) **Non-Basic Services**: Non-Basic Services include all other services currently offered by Southern Bell which have not been classified as Basic or Interconnection



11/13/94

### III. PRICE REGULATION

(a) From the effective date of this plan the Commission will regulate the prices of the services provided by Southern Bell to the public as provided in this plan, rather than regulating the earnings of the Company in its entirety.

(b) On the effective date of this plan, all existing rates, terms and conditions for the services provided by Southern Bell contained in its then existing tariffs and contracts are deemed just and reasonable.

(c) Rates for basic services existing on the effective date of this plan shall be the maximum that Southern Bell may charge for such services for a period of five years from the date of approval of this plan. This provision shall not apply to rate adjustments authorized as a part of the Commission's order dated June 2, 1994 in Docket No. 4684-U In Re: Atlanta Metro Extended Area Service Expansion.

(d) After the expiration of this five year period, the change in basic service rates, in the aggregate, is capped at the level of inflation. Southern Bell is authorized to adjust the cap on an annual basis, at a date selected by Southern Bell. The adjustment for the first year after the expiration of this time period, and each succeeding year, shall not exceed the change in the GDP-PI from the immediately preceding year. Rate adjustments for basic services, in the aggregate, shall not exceed the established cap. Rates for individual services or groups of services in the basic services category may be increased or decreased by varying amounts as long as the overall rate changes do not exceed the cap. If rates are not adjusted by the full amount allowed by the cap in a particular year, the amount not used may be carried over to future years.

(e) Southern Bell is authorized to set the rates, terms and conditions for interconnection services based on market considerations. The Company may establish flexible pricing options, including but not limited to volume discounts for all interconnection services.

(f) Southern Bell is authorized to determine the prices, terms and conditions for all non-basic services based on market considerations. These services may be provided by Southern Bell through tariffs, written contracts or other commercially reasonable means.

(g) Notwithstanding the provisions of Subsections (c) and (d) of this Section, the financial impact of governmental mandates which apply specifically and exclusively to and have an impact on telecommunications companies, including, but not limited to, separations changes ordered by the Federal Communications Commission, may be recovered through an adjustment to rates for basic services, or from other rates as designated by Southern Bell. Within 60 days of the occurrence of such changes, Southern Bell shall notify the Commission of its intent to adjust its basic service rates. Such notice shall provide a schedule of the adjusted rates and the effective date of the adjusted rates.

(h) After the effective date of this plan, Southern Bell shall not be required to seek regulatory approval of its depreciation rates or schedules in Georgia nor will it be required to produce intrastate financial statements for Georgia. Nothing in this subsection will be construed to prevent the Commission from requiring that Southern Bell demonstrate that any rate change comports with the requirements of this plan.



#### **IV. TARIFFS**

(a) Except as provided in Section III(c) above, Southern Bell may file new or revised tariffs with the Commission covering any service provided by the Company.

(b) Any tariff covering any new service shall be presumed to be valid and shall be effective upon 14 days notice. Any changed tariff reducing the price of an existing service or not affecting the existing rate shall be effective on 7 days notice. Any changed tariff increasing the rates for an existing service shall be effective on 14 days notice. Southern Bell will not change the price of individual services, absent a compelling market need, more than one time in each calendar year.

(c) Southern Bell may file a tariff reclassifying a service from one service category to another. Such tariffs shall be presumed valid and shall be effective on 14 days notice. In the event that the Commission chooses to do so, it may investigate to determine whether such reclassification was appropriate. Such investigation shall not delay the implementation of the reclassification, but if the Commission determines the reclassification to be in error, it may order a change, subject to the appropriate administrative and judicial reviews.

#### **V. UNIVERSAL SERVICE PROVIDER**

Nothing in this plan shall limit or abrogate Southern Bell's universal service obligation under existing law nor authorize it to abandon basic service to any of its local calling areas without the approval of the Commission.

## **VI. QUALITY OF SERVICE**

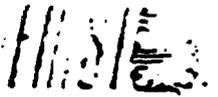
Southern Bell shall continue to monitor and measure service as provided in the Rules and Regulations of the Commission as may be amended from time to time.

## **VII. COMMISSION AUTHORITY**

Nothing in this plan shall abrogate, limit or otherwise diminish the powers and duties of the Georgia Public Service Commission as established by the Constitution and statutes of this State. Under this plan, the Georgia Public Service Commission will continue to monitor Southern Bell's compliance with the terms of the plan, to resolve complaints and petitions by subscribers of Southern Bell's services and to monitor the quality of the basic services provided by Southern Bell.

## **VIII. EFFECTIVE DATE**

This plan shall be effective as of July 1, 1994, or upon approval by the Commission whichever is later.



## ATTACHMENT TO APPENDIX A

CATEGORIES OF SERVICES1. Basic

Includes those services required to provide flat rate basic local exchange service to residential and single-line business customers. Services in this category are:

- Flat rate residential basic local exchange services
- Flat rate single-line business local exchange service
- Basic service connection charges associated with the above services

2. Interconnection

Includes those services which provide access to Southern Bell's local exchange or toll network for the purpose of enabling another telecommunications provider to originate or terminate telecommunications services. Examples of services in this category are:

- Interconnection for mobile services
- Public telephone access service for CPE
- Sharing and resale of basic local exchange service
- Special access service
- Switched access service

3. Non-Basic

Includes all other services currently offered by Southern Bell which have not been classified as Basic or Interconnection. Examples of services in this category are:

- Custom calling services
- Directory assistance service
- ESSX® service
- Long distance services
- Measured and message local exchange service
- Multi-line business local exchange service
- Operator services
- Private line services
- Public telephone service
- Touchstar® services
- Touchtone service
- White pages directory listings

In the  
UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA )  
 )  
Plaintiff, )  
 )  
v. ) Civil No. 82-0192 (HHG)  
WESTERN ELECTRIC COMPANY, INC. )  
and AMERICAN TELEPHONE AND )  
TELEGRAPH COMPANY, )  
 )  
Defendants. )

COMMENTS ON THE MOTION  
OF BELL ATLANTIC, BELLSOUTH, NYNEX  
AND SOUTHWESTERN BELL TO VACATE THE DECREE

Nextel Communications, Inc. ("Nextel") hereby submits these comments to the Department of Justice in response to the order of the U.S. District Court on August 18, 1994, inviting comment on the Motion to Vacate the Decree submitted by Bell Atlantic Corporation, BellSouth Corporation, NYNEX Corporation, and Southwestern Bell Corporation (hereinafter "the Bell Companies" or "the BOCs").<sup>1/</sup>

Nextel submits that the BOCs continue to control essential network bottlenecks and use them to forestall the introduction of substantial competition in the local

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<sup>1/</sup> Although Ameritech is not party to the motion, it previously filed its own motion with the Department seeking interexchange relief. Nextel previously filed comments with the FCC on Ameritech's motion. See Reply Comments of Nextel Communications, Inc., filed September 17, 1993 in the Petition for Rulemaking to Determine the Terms and Conditions Under Which Tier 1 LEC's Should be Permitted to Provide InterLATA Telecommunications Services, RM-8303.

telecommunications market despite existing regulations aimed at limiting anti-competitive behavior. Additionally, Nextel's own experience in the wireless market demonstrates that potential competition is not a sufficient predicate for lifting the Decree. Accordingly, vacating the Decree at this time could adversely affect the viability of future local loop competition.

Nextel holds Federal Communications Commission ("FCC" or "Commission") licenses for Specialized Mobile Radio ("SMR") systems in the nation's largest markets. Nextel conceptualized and is implementing Enhanced Specialized Mobile Radio ("ESMR") systems all in advanced digital mobile technology to offer a unique combination of cellular, dispatch, paging and data transmission services using a single handset with a single telephone number over a single integrated network.

Nextel has spent approximately \$1 billion to develop and implement advanced, wide-area ESMR services capable of offering the first real competition to the cellular duopoly. As a new entrant wireless competitor, Nextel advocates competition in lieu of regulation where markets are truly competitive. Unfortunately, this is not yet the case for the local wireline exchange.

Regardless of recent technical advancements by interexchange, wireless and local service providers, the BOCs continue to control access to essential local bottleneck facilities, telephone numbering and code assignments, and network functions and databases. This control permits the BOCs to

inhibit the development of present and future local services competitors -- which they have a powerful incentive to do, particularly when their affiliates provide competitive services such as Commercial Mobile Radio Services ("CMRS").

Despite the initiation of public policy initiatives aimed at reducing the scope of the BOC bottleneck or the degree of anti-competitive behavior, the BOCs' ability and incentive to use their networks to disadvantage new competitors has not been diminished or diluted. Although some competitors exist and compete on the fringes of the local telecommunications market, most are still nascent, operating in either limited, distinct submarkets or not yet operating at all. Without the Decree's continued protection, new potential competitors, including CMRS providers, will have little chance to actually compete with the still-dominant BOCs. This provides no basis for the lifting of any Decree barrier.

A. BOC Control Over Vital Services And Functions Continues to Create Barriers to Competition.

The purpose behind the Decree is the encouragement of competition, not only among AT&T and its former Bell System affiliates, but also among new and yet to be established enterprises. With few exceptions, new telecommunications service providers continue to face substantial barriers to competition with the BOCs. Federal and state structural regulations often do little more than require the BOCs to window dress the services they decide to provide to their affiliates and competitors to

ensure that there is no facial argument of unreasonable discrimination. As the BOC Motion appears to acknowledge, however, the non-discrimination requirements of the MFJ were intended to look beyond existing regulatory failures and create markets where competition could evolve. In this regard, the Decree has not outlived its usefulness.

The BOCs exercise control over numbering code assignments and other essential network bottlenecks. This control historically has been used to put obstacles in the path of existing and would-be competitors. Misuse of this network control function is particularly acute when the BOC affiliates also provide services in competition with non-BOC affiliates, as in the wireless market. Regulation by the FCC or state regulators has not proved sufficient to prevent recurring and substantial anti-competitive behavior.

1. BOCs Have Failed to Honor Existing Interconnection Obligations.

High quality, broadly available BOC network interconnection that is unbundled and cost-based is critical if competition is to replace monopoly. The frustrating experience of private carriers, interexchange carriers, cellular service providers and other CMRS providers in obtaining fair, cost based interconnection from the BOCs demonstrates the need for continued

vigilance both by federal and state regulators and the MFJ Court.<sup>2/</sup>

For example, despite the existence of federal policies requiring reciprocal compensation for wireless carriers that originate and terminate local traffic, the BOCs have failed to implement this requirement in their interconnections with wireless service providers.<sup>3/</sup> Further, the BOCs' ability to set interconnection and compensation rates relative to the actual costs of interconnection allows them to manipulate the costs of their competitors and dictate the terms of competition.

Moreover, granting wireless service providers a right to basic network interconnection does not suffice. BOC network functions, including access to network signalling databases and telephone numbers, must be made available to CMRS providers on an equal basis.

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2/ See Declaratory Ruling, The Need to Promote Competition and Efficient Use of the Spectrum, 2 FCC Rcd 2910 (1987) aff'd on recon. Memorandum Opinion and Order on Reconsideration, 4 FCC Rcd 2369 (1989). Under these circumstances, the Department has been understandably cautious in its endorsement of broad based MFJ interexchange relief for wireless services. See e.g., letter from Richard L. Rosen, Chief Communications and Finance Section to Michael K. Kellogg, Esq., BOC counsel, regarding DOJ investigation of BOCs Request for a Generic Wireless Waiver, June 14, 1994.

3/ See Second Report and Order, 9 FCC Rcd 1711, 1797-1501 (1994) and Notice of Proposed Rulemaking and Notice of Inquiry, CC Docket No. 94-54, FCC 94-145 (adopted August 30, 1994, released July 1, 1994) at ¶ 102-120. Similarly the proposed Telecommunications Infrastructure Act of 1993, S. 1822, endorsed the principle of reciprocal compensation and other forms of network coordination between all telecommunications service providers.

Network unbundling requirements are pointless if the BOCs retain complete network control and the ability to strategically price unbundled functions and basic network interconnection. Because the BOCs can use their control over pricing in anti-competitive ways, it is critical to the emergence of alternative, flexible, high capability networks that potential competitors are able to purchase these functions and services at cost-based rates.

2. Recent experience with BOC controlled numbering assignments demonstrate continuing anti-competitive behavior.

Telephone numbers are a scarce resource. Both access to and the assignment of blocks of telephone numbers (central office or NXX codes) is a necessary predicate to local interexchange and wireless competition. Even more important is the development and enforcement of a timetable for implementing full number portability. Despite the scarcity of this essential resource, the BOCs continue to control the assignment of NXX codes through Bellcore, the entity charged at divestiture with the responsibility for numbering administration and BOC centralized organization and network planning. Nextel and other wireless service providers have filed comments before the Commission regarding Bellcore's inherent bias in the discharge of its numbering administration responsibilities and the need to

establish an independent numbering plan administrator with representation from all industry segments.<sup>4/</sup>

Ameritech's recent numbering proposals in Chicago demonstrate its bias against non-BOC entities and against new market entrants, both wireline and wireless. In light of the apparent imminent exhaust of numbers in the 708 area code, Ameritech initially proposed forcing wireless customers to give back the seven digit telephone numbers previously assigned to their cellular phones and pagers in exchange for 10 digit numbers under an exclusive wireless area code (NXX code). Under Ameritech's original plan, customers would have had to return their units for reprogramming, convert to ten digit dialing and lose the commercially valuable geographic identity of the existing area codes in the Chicago metropolitan area -- while Ameritech's own wireline telephone customers would have been unaffected.

After objections from the wireless industry, Ameritech proposed an all-service overlay NXX code and no reprogramming. Not surprisingly, this plan revision has ameliorated the objections to the renumbering plan of its cellular affiliate, Ameritech Mobile, and the other BOC-affiliated cellular

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4/ See Comments of Nextel Communications, Inc., Administration of the North American Numbering Plan, CC Docket No. 92-237 Phases One and Two (filed June 7, 1994); Reply Comments of Nextel Communications, Inc., Administration of the North American Numbering Plan, CC Docket No. 92-237 Phases One and Two (filed June 30, 1994). See CTIA Ex Parte Letter to Chairman Hundt, CC Docket 92-237, (October 28, 1994)

duopolist, Southwestern Bell Mobile (d/b/a/ Cellular One). Ameritech's current proposal, however, expressly denies any additional commercially and competitively valuable 708 NXX codes to Nextel -- a potential competitor -- even though approximately half a million 708 NXX numbers remain available for assignment.

In other words, Ameritech, the NXX code administrator in the Chicago area, and the BOC-affiliated cellular incumbents, are attempting to discriminate against the new entrant Nextel to preserve their competitive advantage in access to customer-preferred numbering assignments. This violates Bellcore's "first-come, first-served" numbering assignment policies and the anti-discrimination provisions of Section 201 and 202 of the Communications Act of 1934, as amended.<sup>5/</sup> That this is happening today sharply illustrates why the BOCs' Motion to Vacate should not be granted so long as they have the ability to engage in discriminatory practices in administering bottleneck local exchange facilities, resources and services.

The local telephone companies in Los Angeles, Houston and Miami are also proposing the assignment of 10 digit numbers to wireless subscribers only. The cost and confusion of these changes will harm wireless providers and their customers, while the BOCs will benefit. Additionally, these number give-backs disproportionately harm the newest service providers, such as

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<sup>5/</sup> 47 U.S.C. §§ 201, 202.

Nextel, which do not have a ready supply of NXX codes from which to assign numbers to their customers.

The inability or unwillingness of the FCC to formulate uniform rules to deal with these recurring number assignment problems or to regulate the BOCs' administration through Bellcore of numbering resources is demonstrated by another recent incident. In June of 1993, Bellcore informed the FCC by letter of its intention to commence assigning the 500 Service Access Codes ("SACs") to carriers demonstrating a present need for mobile uses.<sup>6/</sup> This proposed assignment was to take place without any guidelines in place to assess the genuine nature of the purported need, or to assure that later-entering carriers would have a reasonable opportunity to receive a SAC. Only after Nextel and several other carriers protested did the Commission place Bellcore's plan on hold, inviting Bellcore to provide more explicit information regarding the fairness of its process and requesting Bellcore's assessment of a timetable to make the 500

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<sup>6/</sup> SACs are area codes that are assigned for use throughout the North American Numbering Plan area, unlike traditional geographic area codes, which are assigned to specific areas. These codes provide the means for identifying particular calling attributes and telecommunications services, (i.e., the 800 SAC code denotes toll free calls). The 500 SAC has been allocated for personal communications services numbers that identify an individual wherever he or she may be located, rather than a geographic station.