Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC 95-31

In the Matter of	)	
	)	
Southwestern Bell	)	AAD 95-32
Telephone Company	)	

ORDER TO SHOW CAUSE

Adopted: January 26, 1995 Released: March 3, 1995

By the Commission:

I. Introduction

1. On May 19, 1994 we released a federal-state joint audit report ("Audit Report") that examined transactions between Southwestern Bell Telephone Company ("SWBT") and various SWBT affiliates, including its parent, Southwestern Bell Corporation ("SBC"), and Southwestern Bell Asset Management, Inc. ("AMI").[1] The audit report found various apparent violations of our rules in the accounting methodologies and practices employed by SWBT to book charges for services provided by affiliates to SWBT.[2] We directed the Common Carrier Bureau to review the report and propose appropriate Commission action. This Order directs SWBT to show cause why we should not find that certain SWBT and

[1] Audit Release Order, 9 FCC Rcd ___ (1994) (Audit Release Order). Besides this Commission, the members of the joint audit task force included representatives of the telecommunications regulatory commissions of Arkansas, Kansas, Missouri, Oklahoma and Texas. The Joint Audit Report consists of the the auditors' findings ("Audit Report"), a reply to these findings by SWBT ("SWBT Analysis") and the auditors' response to that reply ("Audit Team Reply").

[2] The joint audit was a comprehensive audit of affiliate transactions between SWBT, which provides regulated telecommunications services within its franchise areas, and numerous affiliates. The Audit Report found apparent rule violations or accounting irregularities only in certain cases involving transactions flowing from SBC and AMI to SWBT. The Audit Report further concluded that, in other transactions involving SWBT and Southwestern Bell Technology Resources, Inc. (TRI), Southwestern Bell Telecommunications, Inc. (Telecom) and Southwestern Bell Mobile Systems, Inc. (SBMS), there was no evidence to indicate there had been Commission rule violations or that telephone ratepayers had been adversely affected by the investigated transactions.

affiliate accounting practices, associated with the allocation of costs and recorded charges for affiliate transactions, violate Commission rules. We also order SWBT to show cause why this Commission should not, as a result of said findings, take appropriate enforcement action, including issuing a Notice of Apparent Liability for Forfeiture,[3] and ordering SWBT to bring its accounting practices into conformity with Commission policies and rules governing affiliate transactions and associated cost accounting.

II. Background

2. The joint audit of SWBT is one of several joint audits undertaken, or contemplated, with state regulatory commissions that share jurisdiction with the Commission over telecommunications common carriers under the Communications Act of 1934.[4] The SWBT joint audit constitutes a notable first in that all of the jurisdictions that regulate a local exchange carrier's provision of telecommunications services participated. For purposes of the audit, this Commission's cost allocation and affiliate transactions rules were applied. The audit covered calendar years 1989 through 1992, during which period SWBT's affiliates billed it approximately $880 million, while SWBT billed approximately $129 million to the affiliates.[5] When we authorized release of the Audit Report last May, we did so without accepting or affirming any of the report's analyses or conclusions. After reviewing the Audit Report, we conclude that it identified a number of significant anomalies in the accounting methodologies and practices used by SWBT and its affiliates. We find that these anomalies warrant further investigation by the Commission and may well require corrective action.

3. The affiliate transactions rules are part of the Uniform System of Accounts ("USOA") that the Commission promulgated so that carriers will record their costs and revenues in a uniform and systematic manner.[6] Generally, that system requires carriers to record as costs and revenues the actual amounts they pay to, or receive from, their suppliers and customers. Such an approach, however, is inadequate to protect ratepayers when the transactions involve carriers dealing with affiliates rather than third parties. In such instances, we have found that the amounts paid to or received from affiliates for goods and services are not an accurate indication of the transaction's value.[7] The Commission developed its affiliate transactions rules to provide a valuation methodology for transactions where regulated

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[3] See 47 C.F.R. § 1.80.

[4] See 47 U.S.C. § 152.

[5] Audit Report, at C-5.

[6] See 47 C.F.R. § 32.1.

[7] See Amendments of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and their Nonregulated Affiliates, Notice of Proposed Rulemaking, 8 FCC Rcd 8071, at 8071-8072 (1993).

carriers are not dealing at arm's length. These rules have become more important over the past few years as telecommunications carriers have diversified to offer a wide variety of regulated and nonregulated products and services.

4. The affiliate transactions rules were adopted in the Joint Cost proceeding, which also promulgated rules governing the apportionment of carriers' costs between regulated services and nonregulated activities.[8] The carriers are required to apply these cost apportionment rules in developing their cost allocation manuals (CAMs) which describe in detail how costs are apportioned to regulated and nonregulated operations. The CAMs also identify each affiliate that engages in transactions with a carrier, and describe the nature, terms and frequency of those transactions.[9]

III. Issues Involving SWBT and SBC

5. SBC is one of seven regional Bell holding companies. SBC and its subsidiaries provide, inter alia, telephone service, customer premises equipment (CPE), yellow pages advertising, printing and distribution of telephone directories, wireless communications services, as well as various product management and support services. SBC provides management services for the corporation, including present and future subsidiaries. SBC also pursues new business opportunities and manages corporate investments.[10]

6. The Audit Report alleges three apparent violations of the Commission's cost allocation rules associated with SBC's accounting for transactions with SWBT: (1) lack of supporting documentation for time charged by SBC employees; (2) use of an improper marketing allocator; and (3) improper use of the general allocator.

A. Lack of Supporting Documentation for SBC Employee Time Charging

7. The amounts that SWBT records in its USOA accounts for services obtained from SBC are determined by SBC's system for allocating costs between regulated and nonregulated operations. SBC's cost allocation system, in turn, is primarily driven by costs based on time charged by employees. Such costs are allocated between regulated and nonregulated services based on the relative amounts of time an employee spends on different activities that are assigned to regulated and nonregulated operations. Therefore, the accuracy

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[8] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298 (Joint Cost Order), recon., 2 FCC Rcd 6283 (1987) (Joint Cost Reconsideration Order), further recon., 3 FCC Rcd 6701 (1988) (Further Reconsideration Order), aff'd sub nom. Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

[9] 47 C.F.R. § 64.903(a). See Affiliate Transactions Notice, 8 FCC Rcd 8071, at para. 7. Only AT&T and those local exchange carriers (LECs) having annual revenues of $100 million or more are required to file CAMs.

[10] Audit Report, at D-14.

of SBC's cost allocation system depends on whether employees are accurately recording their time spent on regulated and nonregulated activities and on whether SBC's cost assignments accurately reflect work time. The auditors discovered that, for 1989-1992, the factors that SBC used to allocate its costs could not be substantiated by any underlying documentation. For example, neither historical time studies nor any contemporaneous records exist to support SBC's cost allocations to subsidiaries.[11] SWBT asserts that SBC relies on annual and periodic time reviews by employees and supervisors to verify that the employee's time is being spent according to cost categories and percentages which the employee must review at the time the employee reviews his or her time card.[12] SWBT argues that SBC trains its employees to take their time review obligations seriously, and that its periodic reviews render time studies unnecessary. The auditors maintain that, regardless of the specific reporting and review system employed by SBC, they cannot meaningfully audit that system unless there are records such as time studies, or contemporaneous employee work records.[13]

8. SWBT counters that its employee time cards and explanations of its time review procedures , coupled with on-site employee interviews conducted by the auditors, should be sufficient to verify the accuracy of SBC's time charging practices.[14] SWBT further states that, while it does not dispute the auditors' authority to examine the survey time reports SBC used to allocate its employees' time and associated costs between regulated telephone and nonregulated activities, it does challenge the power of the auditors, or this Commission, to impose documentation requirements on nonregulated affiliates without "due process."[15]

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[11] Time studies provide a record of an employee's actual work-time spent within a defined period. The results are used to identify the work categories and the percentages of work time spent within those categories that will be the basis for allocating employee costs.

[12] According to verbal information provided by SWBT to Commission staff, besides annual employee/supervisor review, the employee is instructed to review his or her semi-monthly time card and is directed to consult with the appropriate supervisor if actual time spent is at variance with the cost categories and percentages. According to SWBT, the time cards also provide for exception time reporting where the employee spends time on other projects not in the assigned work categories within the two week review period.The auditors, however, dispute that this information was contained on the time cards they were shown.

[13] Audit Report, at D-13.

[14] In the absence of time studies, the task force auditors interviewed 43 SBC employees in order to ascertain whether some type of corroborative evidence existed theat might assist the auditors to review the accuracy of SBC time reporting. The survey time reports were not provided to the auditors and SBC explained that they were not retained and that, at one time, a four week time study had been performed. SBC has since revised its written procedures and now apparently requires each employee to provide the documentary support used to justify cost assignments and percentages.

[15] SWBT Analysis, at E-5, n.5.

9. SBC's argument misses the point; the auditors are not imposing new or unlawful documentation requirements on SBC, but, rather, seeking to evaluate the costs SWBT has entered on its books for its transactions with SBC. Consequently, the auditors properly requested contemporaneous documentation to analyze the work functions SBC had developed for its time reporting system, and documentation to evaluate the accuracy of individual employee time reports. Neither could be provided to the auditors. Moreover, the SBC employees interviewed by the auditors were unable to produce contemporaneous records documenting how they spent their time. In the absence of time studies or contemporaneous records, the auditors could not conclude that SBC employees were reporting their time accurately or that SWBT was complying with our rules in accounting for its transactions with SBC.

10. Our auditing of regulated carriers like SWBT is severely compromised if we cannot evaluate the cost inputs that form the basis of cost allocations to carrier operations. Accordingly, in the Joint Cost Order, we specifically imposed on local exchange carrier nonregulated operations those marketing personnel cost documentation requirements we had earlier imposed on AT&T in authorizing that company's nonregulated provision of customer premises equipment (CPE) and enhanced services.[16] When the Common Carrier Bureau, acting on delegated authority, subsequently endorsed AT&T's cost allocation plan, it underscored the importance of auditing to ascertain whether AT&T's time reporting plan actually produced lawful cost allocations. Further, the Bureau explicitly concluded that only contemporaneous records, or other auditable data, could ensure an accurate audit.[17] We also stated clearly in the Joint Cost Order that we generally expected carriers "[to] maintain a complete audit trail of all cost allocations and affiliate transactions."[18]

11. In this case, it might be true that SBC's time reporting system can produce accurate time reporting, but there is no way for us to tell if the company has not performed periodic time studies or if the employees who are responsible for implementing that system do not prepare and retain contemporaneous documentation. Moreover, contrary to SWBT's assertion, an audit limited to examining the existing time reports would be useless. Although SBC's system apparently requires biweekly review by each employee of his or her work allocations as listed on time cards, it is unlikely that the employee's time would, in every two week period, exactly conform to those allocation percentages specified. Thus, it would appear to be the case that the employee must somehow "recollect" previous reports in order to verify that, over time, his or her reported time falls within the stated categories and

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[16] Joint Cost Order, 2 FCC Rcd 1298, at paras. 190, 207-208, 242. Sections 215, 218 and 219 of the Communications Act, 47 U.S.C. §§ 215, 218 and 219, authorize us to require production of this documentation.

[17] Furnishing of Customer Premises Equipment and Enhanced Services by American Telephone & Telegraph Company, CC Docket 85-26, Mimeo no. 5652, at para.31, released July 11, 1986 (Common Carrier Bureau). The Commission extended the six month record retention requirement imposed on AT&T to 1 year for affected LECs in the Joint Cost Order. Joint Cost Order, 2 FCC Rcd 1298, at para. 208.

[18] Id., at para. 242.

at the listed percentages. If that recollection is not based on auditable, contemporaneous documentation, it is reasonable to ask how accurate it can actually be. This inquiry, however, is not driven by any desire to impose an accounting system on SBC's nonregulated operations. It is driven, rather, by a legitimate need to evaluate SBC's system in order to determine whether SWBT is lawfully accounting for its transactions with SBC.

12. For the foregoing reasons, we order SWBT to show cause why the Commission should not find a violation of section 32.12(b)[19] of the rules governing financial records and documentation. We also order SWBT to show cause why we should not take appropriate enforcement action, including issuing Notices of Apparent Liability for Forfeiture and ordering SWBT, pursuant to sections 215 and 218 of the Communications Act of 1934, as amended,[20] and section 32.12(b) of the rules to furnish contemporaneous SBC employee time charging records for the audit period, or otherwise conduct employee-specific time studies.

B. SBC's Marketing Allocator

13. SBC incurs two kinds of marketing costs. The first are direct marketing costs which are subsidiary-specific and which SBC charges directly to the subsidiary. The second kind of marketing costs are indirect costs, including image advertising, which SBC allocates among the subsidiaries. To do this, SBC uses an allocator that reflects both the direct-charged marketing costs it incurs and the direct-incurred marketing costs of each subsidiary. The auditors found that in 1992 there were no direct-charged marketing costs to SWBT. Nonetheless, nearly 50% of $18.6 million of indirect marketing costs (approximately $9.2 million) was allocated to SWBT. The auditors argue that application of SBC's allocator is improper in such cases because our rules for the apportionment of joint and common costs require, to the extent feasible, the apportionment of costs on the basis of direct assignment or cost causational attribution methods. The auditors concluded that SBC has not used the marketing allocator specified in the Joint Cost Order.[21]

14. SWBT acknowledges that we have ordered telephone companies to reflect marketing costs on a direct assignment basis in their CAMs, but contends that this requirement only applies to telephone company-specific marketing costs.[22] SWBT argues that direct assignment is inappropriate here because the costs at issue are not indirect marketing costs in the usual sense. Rather, SWBT claims that SBC undertakes various projects at the

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[19] 47 C.F.R. § 32.12(b).

[20] 47 U.S.C. §§ 215, 218.

[21] Audit Report, at D-19, D-20, and D-21.The allocator is defined as the ratio of directly assigned and attributable costs to total marketing costs. Joint Cost Order, 2 FCC Rcd 1298, at para. 190.

[22] SWBT Analysis, at E-8.

request of affiliates, including image advertising, which are designed to benefit the entire corporation, according to SWBT, and not just the particular affiliate.[23] Thus, for example, if a charity or public service organization requested SWBT or another affiliate to sponsor an activity, the request would be passed on to SBC. Sponsorship would then be handled typically as a corporation-wide activity to benefit the parent and all affiliates. The allocation approach recommended by the auditors would actually misallocate real costs in such situations, according to SWBT, because a given activity would be allocated solely to the requesting affiliate even though all affiliates benefited.[24] Where, on the other hand, SBC decides to handle sponsorship as an affiliate-specific "event," associated costs are directly assigned to that affiliate.

15. In the Joint Cost Order we recognized the peculiar difficulty in allocating costs associated with the joint marketing of regulated and nonregulated products and services.[25] We abjured a pure direct assignment approach because joint marketing benefits both regulated and nonregulated activities. We also recognized that joint marketing benefits nonregulated services to a disproportionate degree, and such benefits (and associated costs) cannot be captured by direct assignment, or direct or indirect attribution, of costs.[26] In spite of that difficulty, we refused to limit carriers to those marketing efforts that could be directly assigned, or directly or indirectly attributed, because we recognized that regulated activities can legitimately generate so-called residual marketing costs. We specifically identified image advertising as such a residual cost,[27] and prescribed use of a marketing allocator. We clearly intended that all residual marketing costs, including image advertising costs, should be allocated using this approach.[28]

16. Nevertheless, SWBT apparently has identified a significant problem if the marketing allocator prescribed by the Joint Cost Order were to be applied to the way SBC and its affiliates typically conduct marketing operations, including corporate-wide image advertising. SBC's allocation method is based on the advertising dollars spent by each SBC subsidiary, including advertising dollars spent on SBC subidiary-specific advertising "as an

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[23] Id.

[24] SWBT points out that the auditors' approach would routinely missallocate costs if, for example, certain affiliates decided not to use SBC for their company-specific advertising needs but, instead, employed third parties. Notwithstanding that any SBC image advertising would benefit such affiliates, they would avoid paying for such benefits since the marketing allocator formula urged by the auditors would not recognize such advertising costs. SWBT Analysis, at E-9.

[25] Joint Cost Order, 2 FCC Rcd 1298, at paras. 188-208.

[26] Id., at para. 196.

[27] Id., n. 321.

[28] Id., at para. 190.

indication of the importance of advertising to that line of business."[29] It is unclear to us how such an evaluation, unless modified, would take into account those predictable, disproportionate benefits which the Joint Cost Order found (and the auditors affirmed) could attach to nonregulated operations, especially start-up operations which are not otherwise well known in the marketplace.[30] On the other hand, the allocator devised by SBC may be generally consistent with cost causative principles insofar as it addresses the cost avoidance problem identified by SWBT.[31] However, before we authorize use of such an approach, we think further inquiry is necessary. We conclude that further investigation of SBC's allocator method is warranted. In particular, we require a fuller description of the development of its allocator by SBC, including how its method takes into account the disproportionate benefits that nonregulated affiliates may receive from image advertising.

17. Accordingly, pursuant to section 64.901(b)(3) of the Commission's Rules, 47 C.F.R. §64.901 we order SWBT to show cause, why it should not be ordered to modify its cost allocation methodology for image advertising and related residual marketing costs[32] to conform that methodology to the requirements imposed by the Commission's rules and policies.

C. SBC's Use of the General Allocator

18. SBC's system for allocating costs to its subsidiaries follows the cost allocation hierarchy mandated by our rules in that certain "residual" costs are allocated by use of a general allocator as a last resort.[33] The general allocator is employed only after all costs that can be directly assigned are directly assigned and other costs are attributed by use of an appropriate direct or indirect allocator.[34] Our rules mandate that this general allocator is to be computed by using a ratio based upon all expenses directly assigned or attributed to regulated

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[29] SWBT Analysis, at 9.

[30] Audit Team Reply, at F-7.

[31] See para. 14, supra.

[32] In conversations with Commission staff, SWBT indicated that some costs other than image advertising cost are included in those marketing costs subject to allocation by the marketing allocator. See also Audit Team Reply, at F-7. SWBT should include in its discussion a complete description of such other costs. SWBT also should include a complete description of how subsidiary-specific marketing costs are directly assigned and how these subsidiary-specific costs are identified and distinguished from corporate-wide marketing costs.

[33] See Joint Cost Order, 2 FCC Rcd 1298, at para. 152.

[34] See 47 C.F.R. § 64.901(b). Although joint marketing costs are residual costs, the Joint Cost Order mandates marketing cost allocation per application of the marketing allocator discussed in the previous section B of this Order.

and nonregulated activities.[35] The auditors, however, discovered that certain costs retained by SBC were not reflected in the computation of the general allocator. Specifically, the auditors found that SBC did not include "retained expenses" (i.e., certain expenses not passed on to affiliates, but retained on the books of SBC) in the base used for calculating its general allocator. The auditors calculate that if the general allocator had been computed properly, SWBT's share of costs allocated through the general allocator would drop from almost 70 per cent to about 43 per cent for 1992 alone.[36]

19. SWBT counters that its computation of the general allocator properly excluded expenses retained by SBC and that the auditors are incorrect in treating such expenses as "directly assigned to [SBC] stockholders."[37] According to SWBT, "stockholders are not billed for expenses, they are paid dividends."[38] SWBT argues that it would be illogical to include retained expenses in the general allocator computation. First, expenses excluded for one purpose (retention) are included for another (allocation). Second, costs that are not assigned or attributed to subsidiaries are used to determine how costs should be allocated to these subsidiaries. Finally, this can produce "absurd" results such as allocating 43 per cent of SBC's general expenses and generally allocated costs to SWBT which represents 75 per cent of SBC's investment.[39] SWBT also notes that if the auditors' interpretation of the general allocator is correct, that would "likely force SBC to reevaluate its conservative retention policy," and directly assign more costs to subsidiaries like SWBT.[40]

20. The auditors have correctly described how the general allocator should be computed. Further, we agree that the expenses retained by SBC should be included in that calculation. Section 64.901(b)(3)(iii) clearly provides that the general allocator must be computed by using "... the ratio of <u>all</u> expenses directly assigned or attributed to regulated and nonregulated activities."[41] The rules do not provide special treatment for expenses that are retained by an affiliate that happens, as a result of SBC's corporate organization, to be the parent of a telephone company subsidiary (SWBT). Stated another way, the general allocator devised in the <u>Joint Cost</u> proceeding was designed to specify how carriers would allocate residual costs, other than residual marketing expenses, between regulated and nonregulated activities. This same approach was adopted by the Commission to handle the

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[35] 47 C.F.R. § 64.901(b)(3)(iii).

[36] Audit Report, at D-21, D-22.

[37] <u>Id.</u>, at D-22. SWBT Analysis, at E-10.

[38] <u>Id.</u>

[39] <u>Id.</u>, at E-10, E-11.

[40] <u>Id.</u>, at E-11.

[41] 47 C.F.R. § 64.901(b)(3)(iii) (emphasis added).

costing of services provided by affiliates to other affiliates.[42] For our purposes here, SBC is an affiliate like SWBT and the other affiliates, and certain costs that it has, in effect, assigned to itself as retained expenses must be included in the calculation of the general allocator.[43] SWBT's size within the corporation is less relevant in this context than the fact, pointed out by the auditors, that SWBT is direct-charged only 38% of total costs direct-charged to the operating subsidiaries.[44] As to the prospect that SBC might, as a result of our finding, reevaluate its cost retention policy, it can of course do so, subject to regulatory review of the lawfulness of any resultant cost allocations and their impact on telephone ratepayers.

21. We therefore order SWBT to show cause why certain expenses retained by SBC as retained expenses should not be included in the computation of the general allocator used to allocate residual costs to SWBT and SWBT affiliates pursuant to section 64.901(b)(3)(iii).

IV. Issues Involving SWBT and AMI

22. The audit of AMI activities sought to determine whether AMI properly charged for services provided to SWBT and whether SWBT properly recorded those charges. AMI is a subsidiary of SBC which provides various services to SWBT and other affiliates, including employee home relocation services, commercial real estate brokerage services, design and architectural services, and office leasing services. With the exception of home relocation services, SBC also provides all these activities to third parties. AMI also has an ownership interest in Majestic Associates which, inter alia, owns and operates the Hotel Majestic in St. Louis, Missouri. The audit issues that concern us here derive from the charging of reserved hotel accomodations at the Hotel Majestic to SWBT.

A. Reserved Rooms at the Hotel Majestic

23. Majestic Associates owns the Hotel Majestic, a 96-room hotel located near SWBT headquarters in St. Louis, Missouri. Pursuant to a contract entered into by SBC with Majestic Associates, a reserved block of rooms at the hotel (40 for four days per week, 42 weeks per year, and another 10 for 365 days per year) is made available to guests of SWBT

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[42] See 47 C.F.R. § 32.27(d).

[43] The Joint Cost Order specifically adopted a general allocator "based on total company expense," eliminating assets as a factor. Joint Cost Order, 2 FCC Rcd 1298, at paras. 156-159. If SWBT thinks that the real problem connected with its use of the general allocator is that SBC's corporate organization and operations present unique issues not addressed in our Joint Cost or Affiliate Transactions proceedings and, consequently, our rules, SWBT should file a rulemaking petition or otherwise seek appropriate remedy.

[44] Audit Team Reply to SWBT Analysis, at F-9.

and other affiliates. The contract rate of $80 per room per day is paid whether the rooms are occupied or not. While the contract states that SBC shall pay the charges for unoccupied rooms, the auditors found that the hotel instead bills SWBT the contract rate. SWBT records the contract charges in Account 6720, General and Administrative Expense, and a portion of them in its regulated expenses. If a guest employed by any affiliate other than SWBT occupies the room, the hotel charges a weekday rate of $65 and a weekend rate of $49 to the guest's company (e.g., SBC). The difference between these rates and the $80 contract rate was, until recently, paid by SWBT.[45]

24. The auditors concluded that, while a portion of the $80 daily contract charge for unoccupied rooms could be properly allocated to SWBT, the fact that SWBT affiliates also could use these rooms means that those affiliates should also be allocated a portion of the contract charge. The hotel could furnish no invoices or other information identifying when rooms were occupied by SWBT employees or by employees of the affiliates, and the auditors therefore could not readily determine the portion allocable to SWBT. The auditors also found that, since a substantial third party market exists for room rentals, and since the hotel's regular weekend room rate was $49 per day, the $80 per day contract rate could not be fully allocable to SWBT under the affiliate transactions rules which only allow the prevailing company price in such cases.[46]

25. SWBT counters that it is the true beneficiary of contract because the hotel is located near SWBT headquarters and the rooms are frequently occupied by SWBT guests. SWBT concludes, therefore, that the contract charges should be allocated to SWBT. SWBT rejects the auditors' finding about application of a $49 per day weekend market rate because this $49 rate is not standard, and that actual weekend rates vary based on the hotel's anticipated occupancy rate. As a result, SWBT contends, a market price cannot be calculated and the fully distributed cost-based contract rate is authorized under our rules. SWBT says that hotel invoices are not required because, as noted in its CAM, all hotel room charges are based on (and have been established to be below) fully distributed costs, while other charges such as food and beverage are charged at prevailing price.[47]

26. Since SBC effectively reserves more than 50 per cent of the Hotel Majestic's capacity for 42 weeks each year, it appears that a market rate cannot be used as the allocation benchmark. The relevant market consists of blocs of rooms reserved for corporate use and there simply is not enough capacity at the hotel for additional bloc reservations of

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[45] Audit Report, at D-29, D-30. SWBT says this practice has been discontinued. SWBT Analysis, at E-13.

[46] 47 C.F.R. § 32.27(d). The auditors determined that the weekday market rate was $135 per day, and so concluded that the rules did not prohibit allocating the lower $80 per day contract rate for the weekday set-asides. Audit Report, at D-30.

[47] SWBT Analysis, at E-12, E-13, and E-14.

the order of magnitude provided to SWBT. However, this fact is not dispositive as to whether or not a market rate can be developed. Such a determination could only be made if it were shown that capacity was not available at other local hotels to support similar contracts. We order SWBT to show cause that a market rate cannot be developed.

27. We also order SWBT to show cause why it should not discontinue the practice of paying room rate differentials if this practice has not, in fact, already been discontinued. Moreover, the fact that SWBT affiliates uniformly paid the $49 weekend rate seems to undercut SWBT's assertions that such a rate does not reflect true costs for service. This, in turn, raises doubts as to whether the $80 reservation rate is appropriately based on fully distributed costs.[48] Accordingly, we also order SWBT to explain in detail the development of the $80 contract rate and how it reflects our fully distributed costing requirements.

28. Finally, we find SWBT has not established that all of the costs of reserved, unoccupied rooms should be allocated to SWBT. Other affiliates also can use these rooms and are encouraged to do so. SWBT has not shown why other affiliates should not be allocated some of the contract-established costs. Apparently, it will be difficult to establish SWBT's relative use of the hotel given the hotel's invoice procedures, but this difficulty cannot be used to avoid an equitable allocation of cost. Accordingly, we order SWBT to show cause what its lawful allocation of the contract costs should be.

V. Conclusion and Ordering Clauses

29. For the reasons set forth in this Order to Show Cause, we find that the federal state joint audit of SWBT has uncovered accounting practices by SWBT and its affiliates, associated with their allocation of costs and recorded charges and revenues for affiliate transactions, that are apparently inconsistent with Commission rules.

30. Accordingly, IT IS ORDERED, pursuant to Sections 4(i), 4(j), 215, 217-219, and 220 of the Communications Act of 1934, as amended, 47 U.S.C. §§154(i), 154(j), 215, 217-19, and 220, and Sections 1.80, 1.701, 32.12, 32.27, and 64.901 of the Commission's rules, 47 C.F.R. §§ 1.80, 1.701, 32.12, 32.27, and 64.901, that Southwestern Bell Telephone Company SHALL SHOW CAUSE within sixty (60) days of the release date of this Order to Show Cause why the Commission should not conclude that those SWBT and affiliate accounting and cost allocation practices, identified in paragraphs 12, 17, 21, 26, 27 and 28 of this Order, violate Commission rules so that the Commission should take appropriate enforcement action, including but not limited to, issuing Notices of Apparent Liability for Forfeiture and ordering SWBT to improve its internal accounting and cost allocation practices so as to bring those practices into compliance with Commission rules

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[48] Additionally, it would seem that what a hotel charges for its rooms on any given night would be, in part, affected by anticipated occupany rates. The risk of low occupancy rates is considerably mitigated where, as here, a large percentage of total occupany is guaranteed.

and orders.

31. **IT IS FURTHER ORDERED** that the Secretary shall send by certified mail a copy of this *Order to Show Cause* to Southwestern Bell Telephone Company at One Bell Center, St. Louis, Missouri, 63101.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary

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CORRECTED

Report No. CC 95-65 COMMON CARRIER ACTION October 26, 1995

COMMISSION RELEASES SUMMARY OF LOBBYING COSTS AUDIT FINDINGS

The Common Carrier Bureau has completed audits of lobbying costs of each of the Bell Telephone Operating Companies (BOCs) and the Commission is today releasing a "Summary of Audit Findings" to make public the results of the auditors' work. The Bureau's auditors found numerous past violations of Commission rules with regard to the manner in which lobbying costs should be recorded. The BOCs contended that the Commission's definition of lobbying costs needed clarification. Nevertheless, the BOCs have changed their accounting practices to conform to Commission rules and have also adjusted their future rates in response to the Bureau's findings. As a result the Commission has closed the audits without taking further action.

The Summary released today analyzes information obtained from the BOCs regarding their classification of lobbying costs. The Commission's rules require the BOCs to exclude lobbying costs from their interstate telephone costs. The Summary explains that, prior to the audit, the BOCs recorded only minimal lobbying costs in the correct manner. The audit found violations by all of the BOCs, totalling $116.5 million in misclassified lobbying costs. These violations ranged from the failure to record as lobbying costs any portion of their dues to the United States Telephone Association, which had lobbied on behalf of the BOCs during the audit period, to the decision by two companies to limit the definition of lobbying to include only face-to-face meetings of at least an hour in duration with legislators regarding legislation.

The Summary notes that, since the initiation of the audits, the BOCs have changed their accounting practices for such costs to make them consistent with the Commission's rules. The Summary also states that the BOCs have reduced their price cap indices to the extent necessary to eliminate the effect their past accounting practices would have had on future rates. In other words, the potential maximum rate for these access charges will be lowered to account for these past errors. In its October 17th *Order*, the Commission stated that because of these voluntary remedial actions taken by the BOCs, it has closed these audits and plans to take no further action at this time.

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The BOCs requested confidential treatment for all information obtained during these audits. On October 17, 1995, the Commission released a *Memorandum Opinion and Order*, FCC 95-418 ("*Order*"), that denied the BOCs' confidentiality requests to the extent necessary to release the Summary. This *Order* directed the Bureau to release the Summary on the sixth working day following service of the relevant portions of the Summary on each of the BOCs. None of the BOCs received a judicial stay of this Order

Action by the Commission October 4, 1995, by Memorandum Opinion and Order (FCC 95-418). Chairman Hundt, Commissioners Quello, Barrett, Ness, and Chong.

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Lobbying Costs Audits
Summary of Audit Findings

This summary presents the findings of the Common Carrier Bureau's ("Bureau's") Accounting and Audits Division following its audits of lobbying costs at each of the Bell Telephone Operating Companies ("BOCs"). The Bureau audited those lobbying costs directly incurred by the BOCs for the period of 1988 through 1991. It also audited those that the Regional Holding Companies ("RHCs") or other affiliates billed to the BOCs for the same period.

Section 32.7370(a) of the Commission's rules requires the BOCs to record lobbying costs, including those they pay to affiliates, in Account 7370, Special charges.[1] That account includes:

> expenditures for the purpose of influencing public opinion with respect to the election or appointment of public officials, referenda, legislation, or ordinances (either with respect to the possible adoption of new referenda, legislation or ordinances, or repeal or modification of existing referenda, legislation or ordinances) or approval, modification, or revocation of franchises, or for the purpose of influencing the decisions of public officials. This also includes advertising, gifts, honoraria, and political contributions. This does not include such expenditures which are directly related to communications with and appearances before regulatory or other governmental bodies in connection with the reporting utility's existing or proposed operations.[2]

Account 7370 is a below-the-line account.[3] Therefore, absent specific Commission approval, the BOCs must exclude the costs recorded in that account from their interstate cost calculations.[4]

In the 1990 Access Tariff Order, the Bureau found that the BOCs had improperly included lobbying costs in their 1989 revenue requirements.[5] The Bureau disallowed a total of approximately $3.4 million of these expenses, based on estimates

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[1] 47 C.F.R. §32.7370(a).

[2] Id.

[3] Regulators use the terms "above-the-line" and "below-the-line" to help distinguish costs that are chargeable to ratepayers from those that shareholders must bear. Above-the-line costs are presumed to support regulated services. Below-the-line costs are presumed to support other activities.

[4] See 47 C.F.R. §32.7370.

[5] Annual 1990 Access Tariff Filings, Memorandum Opinion and Order, 5 FCC Rcd 4177, 4233-34, para. 509-514 (1990) ("1990 Access Tariff Order").

the carriers provided.[6] To determine whether the BOCs' accounting procedures were otherwise consistent with Section 32.7370(a), the Bureau initiated the subject audits.

The auditors found that, prior to the Bureau's audits, the BOCs had recorded only minimal lobbying costs in Account 7370 because they had applied very narrow definitions of what constituted lobbying. For example, the auditors found that two BOCs had limited the definition of lobbying to encompass only face-to-face contacts with legislators that lasted at least an hour and attempted to influence them on legislation. The auditors also found that most BOCs had misclassified the costs of lobbying-related clerical and staff support, travel, and overheads as operating expenses. The auditors concluded that all of the BOCs had failed to record at least some of their lobbying costs in Account 7370. For instance, according to the auditors, all of the BOCs had failed to record any portion of their dues to the United States Telephone Association, which had lobbied on behalf of the BOCs during the audit period, in that account. They further found that certain BOCs had financed the publication of articles as part of their lobbying efforts without recording the associated costs in Account 7370.

The BOCs maintained that the Commission's definition of lobbying costs needed clarification and that they had made reasonable interpretations of Section 32.7370. Despite these positions, based on discussions with Commission staff after the initiation of the audits, the BOCs prospectively changed their accounting procedures for lobbying costs prior to the completion of the audit. For example, one carrier that had previously defined lobbying costs as including only face-to-face contacts with legislators revised its definition to include:

> amounts paid or incurred for research, or preparation, planning or coordination of, any lobbying activity, as well as travel and entertainment expenses incurred in connection with lobbying activities. In addition to salaries of employees allocable to lobbying activities, these expenses include allocable payroll-related loadings, as well as amounts paid for outside lobbying services.

The auditors found that the changes in the accounting practices were consistent with Section 32.7370 and had substantially increased the lobbying costs recorded in Account 7370. The auditors concluded, however, that additional improvements would be necessary to bring the BOCs' accounting procedures for lobbying costs into full compliance with the Commission's rules. Although the BOCs continued to dispute the auditors' rule interpretations, they nonetheless agreed to make the recommended improvements.

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6 Id. at 4234, para. 514, and 4243, n.146.

The auditors estimated the effect of the BOCs' accounting practices for lobbying costs that the BOCs had recorded in above-the-line accounts, instead of Account 7370. The following table illustrates those estimates:

Misclassified Lobbying Costs--Total Company ($millions)					
Telephone Operating Companies by Region	**1988**	**1989**	**1990**	**1991**	**Total**
Ameritech	5.0	5.0	4.0	4.0	18.0
Bell Atlantic	6.5	6.5	6.5	2.0	21.5
BellSouth	7.0	7.0	7.0	6.0	27.0
NYNEX	6.0	6.0	1.0	1.0	14.0
Pacific Telesis	5.0	5.0	1.0	1.0	12.0
Southwestern Bell	6.0	6.0	1.0	1.0	14.0
US West	2.5	2.5	2.5	2.5	10.0
Total	38.0	38.0	23.0	17.5	116.5

The auditors also addressed the impact that these misclassifications would have on future rates. Since January 1, 1991, the Commission has regulated the BOCs' interstate access charges using the LEC price cap rules.[7] Under these rules, the BOCs established their initial price cap indices based on their projected interstate access revenue requirements for July 1, 1990 to June 30, 1991. With one exception, the BOCs' calculation of those costs in their initial price cap indices reflected the BOCs' improper accounting practices for lobbying costs.[8] Because, under price cap regulation, each succeeding price cap index for a basket of services is a function of the initial price cap index for that basket, the BOCs' price cap indices

[7] See Policies and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) (LEC Price Cap Order), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), modified on recon., 6 FCC Rcd 2637 (1991) (LEC Reconsideration Order), aff'd sub nom., National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

[8] While Southwestern Bell had misclassified lobbying costs during the audit period, it recognized the misclassifications during the 1990 annual tariff filing process and removed the costs from the interstate cost calculations that were used to set its initial price cap index.

for their interstate services (and, by definition, their interstate rates) have continued to reflect the impact of their improper accounting procedures for lobbying costs.[9]

The auditors found that the BOCs had misclassified approximately $38 million in lobbying costs in 1989, with approximately $9.1 million of that assigned interstate. In the 1990 Access Tariff Order, the Bureau disallowed $3.4 million of the interstate costs. Because the BOCs used their accounting results for 1989 to project their interstate access revenue requirements for July 1, 1990 to June 30, 1991, the auditors found that the BOCs needed to make further price cap adjustments totalling $5.7 million. To eliminate the continuing effect of the inclusion of lobbying costs in their initial price caps, the BOCs, without conceding to the auditors' findings, made those adjustments, as set forth below:

Lobbying Costs Price Cap Adjustments ($millions)	
Telephone Operating Companies by Region	**Audit PriceCap Adjustment (1995)**
Ameritech	0.9
Bell Atlantic	1.7
BellSouth	1.5
NYNEX	0.6
Pacific Telesis	0.3
Southwestern Bell	0.0
US West	0.7
Total	5.7

The 1995 Annual Access Tariff Filings reflect these adjustments. Because the carriers have agreed to these and the other above-discussed remedial measures, the auditors concluded that the Commission need not take any further action regarding the BOCs' accounting practices for lobbying costs at this time.

9 See 47 C.F.R. §§61.44(b), 61.45(b)-(c).