

RECEIVED

SEP 10 1996

BEFORE THE  
Federal Communications Commission  
WASHINGTON, D.C.

Federal Communications Commission  
Office of Secretary

In the Matter of

Implementation of the Telecommunications  
Act of 1996:

Accounting Safeguards Under the  
Telecommunications Act of 1996

)  
)  
)  
)  
)  
)  
)

CC Docket No. 96-150

DOCKET FILE COPY ORIGINAL

REPLY COMMENTS OF THE TELECOMMUNICATIONS INDUSTRY ASSOCIATION

Matthew J. Flanigan  
President  
Grant E. Seiffert  
Director of Government  
Relations  
  
**Telecommunications Industry  
Association**  
1201 Pennsylvania Ave., N.W.  
Suite 315  
Washington, D.C. 20044-0407

Philip L. Verveer  
John L. McGrew  
Francis M. Buono

**WILLKIE FARR & GALLAGHER**  
Three Lafayette Centre  
1155 21st Street, N.W.  
Suite 600  
Washington, D.C. 20036  
(202) 328-8000

**ATTORNEYS FOR  
TELECOMMUNICATIONS INDUSTRY  
ASSOCIATION**

September 10, 1996

No. of Copies rec'd  
List ABCDE

*946*

**TABLE OF CONTENTS**

	<u>PAGE</u>
<b>SUMMARY</b> .....	i
<b>I. INTRODUCTION</b> [NPRM Section I.; ¶¶ 1-26] .....	1
<b>II. NEED FOR ACCOUNTING SAFEGUARDS</b> [NPRM Section I.; ¶¶ 1-26] .....	4
<b>III. ACCOUNTING REQUIREMENTS OF SECTIONS 272 (b) (2) AND (c) (2)</b> [NPRM Section III.B.1.b.; ¶¶ 68-69] .....	9
<b>IV. "ARM'S LENGTH" REQUIREMENT OF § 272 (b) (5)</b> [NPRM Section III.B.1.c.; ¶¶ 70-75] .....	11
<b>V. APPLICATION OF STRENGTHENED AFFILIATE TRANSACTIONS RULES</b> [NPRM Section III.A. and III.B.1.c.i-iii.; ¶¶ 62-66 and 76-85] .....	13
<b>A. IDENTICAL VALUATION METHODS FOR ASSETS AND SERVICES</b> [NPRM Section III.B.1.c.i.; ¶¶ 76-79] .....	16
<b>B. PREVAILING COMPANY PRICES</b> [NPRM Section III.B.1.c.ii.; ¶¶ 80-82] .....	19
<b>C. ESTIMATES OF FAIR MARKET VALUE</b> [NPRM Section III.B.1.c.iii.; ¶¶ 83-85] .....	22
<b>VI. AUDIT REQUIREMENTS</b> [NPRM SECTION III.B.1.f.; ¶¶ 92-93] .....	24
<b>VII. SECTION 273 (d) - MANUFACTURING BY CERTIFYING ENTITIES</b> [NPRM Section III.B.2; ¶¶ 95-98] .....	25
<b>VIII. SCOPE OF COMMISSION AUTHORITY</b> [NPRM Section III.B.2.c.; ¶¶ 99-100] .....	28
<b>IX. CONCLUSION</b> .....	30

### **SUMMARY**

TIA urges the Commission, in implementing the accounting safeguard provisions of Section 272, to take steps to ensure that its rules effectively address the full range of risks to competition in the area of manufacturing. The potential risks of cross-subsidy and discrimination in favor of BOC-affiliated manufacturers in the procurement process and in other areas are real and substantial, given the current, immature state of competition in the BOCs' local exchange markets. Effective implementation and enforcement of the accounting safeguards embodied in Section 272 and other relevant sections of the Communications Act, as amended by the Telecommunications Act of 1996, is therefore essential to ensure that the benefits of the current, vigorously competitive domestic equipment marketplace are preserved.

In these reply comments, TIA focuses on the proposed changes to the Commission's affiliate transactions rules. TIA generally supports the Commission's proposals to strengthen the existing rules, in order to address the heightened risks of cross-subsidy and other anticompetitive behavior associated with BOC entry into manufacturing and other previously-restricted activities. TIA's position on specific issues addressed in the Commission's Notice and in the initial comments submitted in this proceeding is as follows:

- TIA believes that neither price cap regulation nor the current state of competition in the local exchange and access markets eliminates the BOCs' incentive to cross-subsidize, through inflated transfer pricing and other cost-shifting mechanisms.

- TIA supports the adoption of rules requiring that the accounting practices of BOCs and their affiliates be fully auditable and comply with GAAP, as well as strengthened affiliate transactions rules.
- TIA believes that requiring compliance with the Commission's affiliate transactions rules, as amended, will help to ensure 1) that BOCs are fully compensated for any goods or services that they provide to their separate affiliates, and 2) that the BOCs do not pay artificially inflated, above-market prices for goods or services procured from their affiliates.
- TIA agrees that all affiliate transactions should be reduced to writing in an auditable form and made readily available for public inspection. In addition, TIA supports requiring each RBOC to provide (and make available for public inspection) periodic reports, on at least a quarterly basis, listing and summarizing all affiliate transactions. All such information should be made available at the BOC's principal place of business and at a central location in the Washington, D.C. area, in written and computer-readable format.
- TIA endorses the Commission's tentative conclusion to adopt uniform valuation methods for assets and services, in order to reduce the risk that BOCs will subsidize their manufacturing affiliates, by providing services to their affiliate at below-market prices or by purchasing equipment and related services from their affiliate at above fair market value.
- TIA also supports the Commission's tentative conclusion to eliminate prevailing company pricing. Instead, the Commission should allow BOCs to use prices charged to third-parties as one of the factors which may be taken into account in establishing fair market value.
- While TIA agrees that the BOCs should be given some degree of flexibility in the procedures used to determine the fair market value of affiliate transactions, TIA believes that the BOCs should be required to act in good faith in making such determinations.
- TIA again urges the Commission to require BOCs to establish and implement appropriate, comprehensive procedures which ensure that products manufactured by BOC affiliates and non-affiliates are accorded non-discriminatory treatment throughout the procurement process.
- BOC procurement procedures also should provide for appropriate documentation and retention of records relating to the application of the established procedures to particular purchases. If properly implemented, such procedures will help

to ensure that sufficient information exists to accurately determine the fair market value of affiliate transactions and to verify that a decision to procure from an affiliate was made in a non-discriminatory manner.

- TIA believes that the biennial audit requirement established in Section 272(d) supplements, rather than replaces, the annual audit required under the Commission's existing rules. TIA also supports the Commission's tentative conclusions regarding the required contents of the audit report.
- TIA believes that auditors' work papers should be available upon request, with appropriate protection for proprietary information, and supports MCI's suggestion that the Commission adopt a rule requiring carriers to maintain a complete audit trail of all cost allocations and affiliate transactions.
- TIA urges the Commission to ensure that appropriate separation exists between any manufacturing activities which Bellcore may be permitted to undertake, consistent with Section 273(d) of the Act, and Bellcore's certification and other ratepayer-funded activities.
- TIA believes that to ensure that Bellcore's ratepayer-funded activities are not used as a vehicle for cross-subsidization of competitive manufacturing activities, the Commission should apply its affiliate transactions rules, as modified, to any transactions between Bellcore and any manufacturing affiliate which it establishes, once it is free to engage in such activities.
- TIA agrees with the Commission's tentative conclusion that the BOC manufacturing activities addressed in Sections 272 and 273 are not within the scope of Section 2(b), and that because such activities cannot be segregated into interstate and intrastate portions, any inconsistent state regulation should be preempted.

BEFORE THE  
Federal Communications Commission  
WASHINGTON, D.C.

RECEIVED

SEP 10 1996

Federal Communications Commission  
Office of Secretary

In the Matter of	)	
	)	
Implementation of the Telecommunications	)	
Act of 1996:	)	CC Docket No. 96-150
	)	
Accounting Safeguards Under the	)	
Telecommunications Act of 1996	)	

**REPLY COMMENTS OF THE TELECOMMUNICATIONS INDUSTRY ASSOCIATION**

The Telecommunications Industry Association ("TIA"), by its attorneys, hereby submits its reply to comments submitted in response to the Notice of Proposed Rulemaking in the above-captioned proceeding,<sup>1</sup> in which the Commission will establish rules to implement the accounting safeguard requirements of Sections 260 and 271 through 276 of the Communications Act of 1934, as amended.

**I. INTRODUCTION [NPRM Section I.; ¶¶ 1-26]**

TIA is a national trade association whose membership includes over 500 manufacturers and suppliers of all types of telecommunications equipment, customer premises equipment

---

<sup>1</sup> Notice of Proposed Rulemaking, In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, CC Docket No. 96-150, FCC 96-309 (released July 18, 1996) (hereinafter, "NPRM" or "Notice").

("CPE"), and related products and services. TIA's members are located throughout the United States, and collectively provide the bulk of the physical plant and associated products and services used to support and improve our domestic telecommunications infrastructure.

As TIA has previously observed, in articulating its position with respect to the non-accounting safeguard issues addressed in CC Docket No. 96-149,<sup>2</sup> implementation of the AT&T Consent Decree ("MFJ") had a dramatic and overwhelmingly positive effect on the telecommunications equipment industry in the United States. The more open, competitive environment which has emerged under the MFJ has yielded enormous benefits to American consumers, the domestic equipment industry, and the U.S. economy, in the form of lower prices, improved quality, and an ever-expanding array of innovative new products, many of them manufactured by firms which did not even exist at the time the MFJ was entered.

In order to ensure that these benefits are not lost or diminished, the Telecommunications Act of 1996 imposes the following conditions on Bell Operating Company ("BOC") entry into manufacturing:

- (1) the BOCs may not engage in manufacturing telecommunications equipment or CPE until they

---

<sup>2</sup> See August 15, 1996 Comments of the Telecommunications Industry Association in response to Notice of Proposed Rulemaking, In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended, FCC 96-308 (released July 18, 1996) ("Non-Accounting Safeguards Notice").

have opened their local exchange markets to competition,<sup>3</sup> and have secured the Commission's approval to provide in-region interLATA services pursuant to Section 271(d) of the Act;<sup>4</sup>

- (2) the BOCs may engage in manufacturing activities only through a "separate affiliate" which complies with the structural separation, non-discrimination, and accounting safeguard requirements established in Section 272 of the Act, as well as the implementing regulations adopted by the Commission,<sup>5</sup> and
- (3) the BOCs must comply with the additional manufacturing-specific safeguards established in Section 273 of the Act and the Commission's implementing regulations.<sup>6</sup>

TIA believes that effective implementation and vigorous enforcement of **all** of the above-described conditions is essential to the maintenance of the current highly dynamic, vigorously competitive domestic equipment marketplace. As the Commission's Notice indicates, the purpose of this proceeding is to establish rules to implement the **accounting safeguards** of Sections 260 and 271 through 276.<sup>7</sup> However, TIA urges the Commission to remain

---

<sup>3</sup> See 47 U.S.C. § 271(c).

<sup>4</sup> See 47 U.S.C. § 273(a). The only exceptions to this requirement relate to previously-authorized activities, which are allowed to continue pursuant to Section 271(f), and those activities which the BOCs are specifically authorized to engage in upon enactment, pursuant to Section 273(b).

<sup>5</sup> See 47 U.S.C. § 272(a)(2)(A).

<sup>6</sup> See 47 U.S.C. § 273.

<sup>7</sup> NPRM at ¶ 2.

cognizant of the interrelationship of the rules adopted in this proceeding with the **non-accounting** safeguards to be established in CC Docket 96-149 and the **manufacturing-specific** provisions of Section 273, which remain to be addressed in a separate proceeding.

## II. NEED FOR ACCOUNTING SAFEGUARDS [NPRM Section I.; ¶¶ 1-26]

As the Commission's Notice indicates, the Section 272 accounting safeguard provisions are intended to address the same concerns addressed by the non-accounting safeguards, namely:

- "to protect **subscribers** to regulated monopoly services provided by the BOCs and, in some cases, other incumbent local exchange carriers against the risk of being forced to 'foot the bill' for the carriers' entry into, or continued participation in, competitive [activities]"; and
- "to promote **competition** in new markets by preventing carriers from using their existing market power in local exchange services to obtain an anticompetitive advantage in those new markets the carriers seek to enter."<sup>8</sup>

TIA believes that these two objectives are generally complementary and mutually reinforcing in nature.

In its comments in response to the Commission's Non-Accounting Safeguards Notice, TIA focused on the need for strict separation and operational independence of the BOCs'

---

<sup>8</sup> NPRM at ¶ 4 (emphasis added). For example, with respect to BOC manufacturing activities, the Commission has expressly recognized that "a BOC may have an incentive to purchase only its own equipment, even if such equipment is more expensive or of lower quality than that available from other manufacturers." Non-Accounting Safeguards Notice, supra n.2, at ¶ 8.

manufacturing affiliate. In these reply comments, TIA focuses on the need for strong accounting safeguards which will work in concert with the non-accounting provisions of section 272 to prevent cross-subsidy and ensure that the BOCs deal with their manufacturing affiliates on a non-discriminatory, arm's-length basis. To achieve this objective, it is critical that the Commission adopt accounting rules which are carefully crafted to ensure that transactions between the BOC and its manufacturing affiliate do not become the vehicle for anticompetitive cross-subsidization. In particular, TIA believes that the adoption and aggressive enforcement of the modified affiliate transactions rules proposed in the Notice is an essential ingredient in the development of a comprehensive set of safeguards which preserves the current, vigorously competitive equipment marketplace and the increasingly strong domestic manufacturing industry which has emerged in the post-divestiture environment.

In its Notice, the Commission appropriately recognizes that significant risks to competition and consumers will exist even after a BOC has satisfied the market-opening "checklist" requirements of Section 271(d)(3)(A) and the Commission has determined that entry into now-prohibited interLATA and manufacturing markets should be permitted, pursuant to Section 271(d)(3)(C).<sup>9</sup> As the Commission has observed, "[the BOCs]

---

<sup>9</sup> NPRM at ¶ 6.

currently possess market share for local exchange and exchange access [services] in areas where they provide such services of approximately 99.5 percent as measured by revenues."<sup>10</sup>

As the Notice indicates, where a BOC is regulated under rate-of-return regulation, a price caps structure with sharing (either for interstate or intrastate services), or a price caps scheme with periodic "X-factor" adjustments based on changes in industry productivity, or is entitled to revenues based on costs recorded in regulated books of account, the BOC may seek to "misallocate to its regulated core business costs that would be properly allocated to its competitive ventures."<sup>11</sup> The Commission should reject the BOCs' unfounded claims that price cap regulation -- even "pure" price cap regulation -- eliminates their incentive to cross-subsidize, through inflated transfer pricing and other cost-shifting mechanisms.<sup>12</sup> As several commenting parties correctly point out, regardless of whether the Commission were at some future point to adopt a pure price cap

---

<sup>10</sup> Id. Moreover, consummation of the proposed Bell Atlantic-NYNEX and PacTel-SBC mergers will result in the consolidation of several of the industry's largest equipment purchasers, thereby enhancing the merged entities' influence in the equipment marketplace.

<sup>11</sup> Id.

<sup>12</sup> See Ameritech Comments at 5-9; Bell Atlantic Comments at 3-6; BellSouth Comments at 5, 10; NYNEX Comments at 4-9; SBC Comments at 6, 26, 36; U S West Comments at 28; USTA Comments at 5-9.

regime at the federal level, the accounting safeguards proposed in the Notice are still required for the following reasons:

- First, the fact is that today price caps are not pure, so safeguards remain necessary in the current environment. Indeed, as one commenter has noted, the majority of states continue to rely on rate-of-return regulation or price cap plans that incorporate sharing mechanisms which preserve the incentive to shift costs.<sup>13</sup>
- Second, even if pure price caps were implemented by the Commission, cost allocation and affiliate transactions rules would still be required. If the Commission intends to monitor BOC performance for regulated services to evaluate whether its price cap system is functioning in a manner consistent with the public interest, or to determine whether adjustments must be made to further the public interest (e.g., periodic adjustment of the productivity factor), then the incentive to shift costs will persist and these accounting safeguards remain essential.<sup>14</sup>

As Dr. Leland Johnson, a leading economist and an expert in this area, has explained:

[E]ven without sharing, price cap regulation resembles rate-of-return regulation with a formal time lag. The federal price cap regime is subject to formal review after some interval whereupon past performance is evaluated (including the historic rate of return) and adjustments are made in the productivity factor and other elements of the formula to bring the projected rate of return in line with what regulators would regard as appropriate. In no sense can the company's prices be regarded in the long-run as frozen irrespective of costs.

To protect against cross-subsidy, price caps would have to be fully divorced from costs, meaning that the

---

<sup>13</sup> See MCI Comments at 6. See also General Services Administration Comments ("GSA Comments") at 7.

<sup>14</sup> See MCI Comments at 6, 39; New York State Department of Public Service Comments at 11.

productivity factor would be fixed now and forever. Under this circumstance, 'pure' price caps that offer full protection do not exist nor can they ever be expected to exist. The reason is simply that regulators cannot in the long run ignore the company's profits or losses. If profits are persistently high, regulators will be under strong public pressure to revise the price cap formula. Conversely, low profit levels or losses will bring pressure to adjust the formula in the other direction.<sup>15</sup>

Given these real-world dynamics, the Commission simply cannot accept the BOCs' arguments concerning the sufficiency of price cap regulation as a basis for eliminating the risks which cross-subsidization in its various forms poses to competition and consumer interests.

The BOCs' further contention that the current state of competition in their core businesses will curtail any incentive for shifting the costs of their affiliate's unregulated manufacturing activities to regulated activities is similarly at odds with the realities of the current marketplace.<sup>16</sup> Given the current, immature state of competition in the BOCs' local exchange markets, the potential risks of cross-subsidy and

---

<sup>15</sup> Declaration of Leland L. Johnson, Ph.D. attached to Comments of National Cable Television Association, filed in response to Transmittal Nos. 741, 786, Amended, CC Docket No. 95-145, November 30, 1995, at 33. See also Non-Accounting Safeguards Notice, supra n.2, at ¶ 136, n.258 ("[T]he possibility of future re-calibration of price cap levels also implies that price cap regulation does not fully sever the link between regulated costs and prices.").

<sup>16</sup> See BellSouth Comments at 8-10; NYNEX Comments at 8; SBC Comments at 12-13; USTA Comments at 9-12; U S West Comments at 16.

discrimination in favor of BOC-affiliated manufacturers in procurement and other areas are real and quite substantial.<sup>17</sup>

Accordingly, TIA strongly urges the Commission, in implementing the accounting safeguard provisions of Section 272, particularly in the area of affiliate transactions, to make every effort to address the full range of risks to competition in manufacturing, in order to ensure that the benefits of the existing, highly-competitive domestic equipment marketplace are preserved.

**III. ACCOUNTING REQUIREMENTS OF SECTIONS 272(b)(2) AND (c)(2)  
[NPRM Section III.B.1.b.; ¶¶ 68-69]**

As the Commission's Notice indicates, the accounting safeguards established for manufacturing and other activities which must be conducted through a separate affiliate include a requirement that all BOC separate affiliates "maintain books, records, and accounts in the manner prescribed by the Commission which shall be separate from the books, records, and accounts maintained by the [BOC] of which it is an affiliate."<sup>18</sup> In addition, Section 272(c)(2) requires that BOCs account for all transactions with their separate affiliates "in accordance with

---

<sup>17</sup> See TIA's August 15, 1996 Comments in CC Docket No. 96-149, at 7-8; Non-Accounting Safeguards Notice, supra, n.2, at ¶¶ 8, 13, 75, 78.

<sup>18</sup> NPRM at ¶ 68 (citing 47 U.S.C. § 272(b)(2)).

accounting principles designated or approved by the Commission."<sup>19</sup>

In implementing the requirements of Section 272(b)(2), the Commission should direct all BOC separate affiliates to maintain their books, records, and accounts in a manner consistent with generally accepted accounting principles ("GAAP").<sup>20</sup> Similarly, in implementing Section 272(c)(2), TIA urges the Commission to adopt the approach proposed in its 1993 Affiliate Transactions Notice, and require that all accounting related to affiliate transactions comply with GAAP, except as otherwise ordered by the Commission.<sup>21</sup> In this regard, TIA believes that the Commission must further require that BOC accounting practices be fully auditable<sup>22</sup> and consistent with the Commission's affiliate transactions rules, as modified in the manner described in Section V below.

---

<sup>19</sup> 47 U.S.C. § 272(c)(2).

<sup>20</sup> Imposition of GAAP accounting requirements received universal support from commenting parties. See Ameritech Comments at 22; Bell Atlantic Comments at 13; BellSouth Comments at 23; LDDS Worldcom Comments at 22-23; MCI Comments at 17; SBC Comments at 46-47; USTA Comments at 22.

<sup>21</sup> See Notice of Proposed Rulemaking, Amendment of Parts 32 and 34 of the Commission's Rules to Account for Transactions Between Carriers and Their Non-regulated Affiliates, CC Docket No. 93-251, 8 F.C.C.R. 8071, 8090-91, at ¶ 51 ("Affiliate Transactions Notice").

<sup>22</sup> In the absence of an explicit requirement which ensures that all transactions between a BOC and its affiliate be auditable, the biennial audit requirement established in Section 272(d) could be rendered meaningless.

**IV. "ARM'S LENGTH" REQUIREMENT OF § 272(b)(5) [NPRM Section III.B.1.c.; ¶¶ 70-75]**

Section 272(b)(5) of the Communications Act, as amended, requires BOC separate affiliates to "conduct all transactions with the [BOC] of which it is an affiliate **on an arm's length basis, with any such transactions reduced to writing and available for public inspection.**"<sup>23</sup> TIA believes that requiring the use of fully auditable GAAP accounting practices and compliance with the strengthened affiliate transactions rules discussed below is essential to effective implementation of the statutory requirement that transactions between a BOC and its separate affiliate be conducted on an "arm's length" basis. TIA also believes that Section 272(b)(5)'s arms-length mandate requires that all pricing of asset or service transfers between a BOC and its Section 272 affiliates must be "compensatory."<sup>24</sup> Use of the affiliate transactions rules, as modified, will help ensure that BOCs are fully compensated for any goods or services that they provide to their separate affiliates, and that they do not pay artificially inflated, above-market prices for goods or services procured from their separate affiliates.<sup>25</sup>

---

<sup>23</sup> 47 U.S.C. § 272(b)(5) (emphasis added).

<sup>24</sup> See NPRM at ¶ 70. See also LDDS Worldcom Comments at 24.

<sup>25</sup> In establishing revised affiliate transactions rules, with the modifications described below, the Commission also should make clear that its rules, as amended, provide no justification for otherwise anticompetitive practices, e.g.,  
(... continued)

Section 272(b)(5) further requires that transactions between a BOC and its affiliate be "reduced to writing and available for public inspection." TIA agrees with those commenters who urge the Commission to require all such transactions to be reduced to writing in an auditable form and made available for public review and inspection.<sup>26</sup> TIA believes that in order for this requirement to achieve its intended purpose, BOC affiliate transactions agreements must be made readily accessible. Toward this end, TIA urges the Commission to require that each of the RBOCs make copies of the relevant documents available for public inspection, both in written form and in an appropriate computer-readable format, at the RBOC's principal place of business<sup>27</sup> and at a central location within the Washington, D.C. metropolitan area.

TIA also supports requiring each RBOC to maintain and update a database listing affiliate transactions and submit to the Commission (and make available for public inspection) periodic reports, on at least a quarterly basis, identifying and summarizing all transactions between the BOCs and their separate

---

(... continued)

below-cost pricing of products by BOC manufacturing affiliates.

<sup>26</sup> See LDDS Worldcom Comments at 24-25; MCI Comments at 30; Telecommunications Resellers Association Comments at 10.

<sup>27</sup> See Bell Atlantic Comments at 17; BellSouth Comments at 24.

affiliates during the relevant period.<sup>28</sup> The availability of reports of this nature will make it easier for the Commission and the public to monitor BOC affiliate transactions and to detect any possible patterns of anticompetitive behavior.<sup>29</sup>

**V. APPLICATION OF STRENGTHENED AFFILIATE TRANSACTIONS RULES  
[NPRM Section III.A. and III.B.1.c.i-iii.; ¶¶ 62-66 and  
76-85]**

As the discussion in Section II (above) demonstrates, neither the existence of price cap regulation nor the current state of competition in local exchange and exchange access markets justifies abandoning the Commission's cost allocation or affiliate transactions rules.<sup>30</sup> Rather, TIA agrees with the Commission and with those commenters who point out that the BOCs continue to possess substantial and persisting market power, and that until meaningful, sustained competition exists in local service markets, cost allocation and affiliate transactions rules remain essential.<sup>31</sup>

---

<sup>28</sup> See MCI Comments at 30.

<sup>29</sup> TIA further urges the Commission to explore the feasibility of making all such information accessible through the Internet, as some parties have suggested. See, e.g., LDDS Comments at 24-25; MCI Comments at 30. To the extent that the relevant documents contain proprietary information, TIA would be willing to support the use of reasonable non-disclosure agreements to ensure that such information is not misused.

<sup>30</sup> See, e.g., USTA Comments at 1-13.

<sup>31</sup> See NPRM at ¶ 6; Competitive Telecommunications Association Comments at 4-5; LDDS Worldcom Comments at 3-9; MCI Comments (... continued)

The Commission also should reject the suggestions of several BOCs that the existing affiliate transactions rules, either without modification<sup>32</sup> or streamlined in various respects,<sup>33</sup> are sufficient to deter the anticompetitive activity that Section 272 directs the Commission to prevent. To the contrary, as the discussion below indicates, allowing BOC entry into manufacturing and other previously-restricted activities creates significant new risks of cross-subsidy and other anticompetitive behavior, which must be addressed through the imposition of strengthened affiliate transactions rules and other accounting and non-accounting safeguards. Accordingly, TIA strongly endorses the Commission's tentative conclusion that modifications to the existing affiliate transactions rules are required, in order to ensure that BOCs do not misallocate costs or discriminate in favor of their Section 272 affiliates.<sup>34</sup>

Two overriding factors justify strengthening the affiliate transactions rules in the manner described in the Notice. First,

---

(... continued)

at 5; New York State Department of Public Service Comments at 10.

<sup>32</sup> See BellSouth Comments at 5-6; NYNEX Comments at 9-20; SBC Comments at 26.

<sup>33</sup> See Ameritech Comments at 18; USTA Comments at 14.

<sup>34</sup> See NPRM at ¶ 11. TIA addresses the Commission's specific proposals to modify the affiliate transactions rules in Sections V.A-C below.

contrary to the assertions of certain BOCs, there is ample evidence in the record demonstrating that the Commission's existing rules are insufficient and that increased accounting safeguards are required. In its Notice, the Commission observes that it has had more than eight years of experience with the existing affiliate transactions rules.<sup>35</sup> On the basis of this experience, the Commission has concluded that amending certain aspects of the existing rules "might provide more optimal protection against subsidization."<sup>36</sup> Indeed, the Commission found the current rules to be inadequate as far back as 1993:

We have over six years of experience in applying these valuation methods. That experience has let us analyze the bases for and practical effects of the present methods in far greater detail than was possible prior to their adoption. . . . [W]e believe the present mix of valuation methods may not be optimal for protecting ratepayers against cross-subsidization.<sup>37</sup>

In addition, the comments received by the Commission include specific references to a number of recent state and federal audits which highlight the fact that BOCs repeatedly have engaged in improper misallocation of costs under the current rules and that stronger accounting safeguards are needed to deter this anticompetitive activity.<sup>38</sup> Equally importantly, as several

---

<sup>35</sup> NPRM at ¶ 65.

<sup>36</sup> Id.

<sup>37</sup> Affiliate Transactions Notice, supra n.21, at ¶ 9.

<sup>38</sup> See MCI Comments at 6-10.

commenters correctly observe,<sup>39</sup> removal of the MFJ restrictions on BOC entry into manufacturing and other adjacent competitive markets has materially increased the risk of cross-subsidization and discrimination, and has thereby increased the need for more stringent accounting safeguards.

TIA's views with respect to the specific modifications proposed by the Commission, in an effort to address weaknesses in the existing affiliate transactions rules, are as follows:

**A. IDENTICAL VALUATION METHODS FOR ASSETS AND SERVICES  
[NPRM Section III.B.1.c.i.; ¶¶ 76-79]**

TIA joins those commenters who support the Commission's proposal to adopt uniform valuation methods for assets and services.<sup>40</sup> The Commission's Notice, together with the initial comments received by the Commission, identify the principal problem created as a result of the current rule's reliance on fully distributed cost valuation in the service context, i.e., the current rules make it possible for subject carriers to sell services for less than fair market value and to pay affiliates more than fair market value for services.<sup>41</sup>

---

<sup>39</sup> See Competitive Telecommunications Association Comments at 6; MCI Comments at i-ii; 3-4.

<sup>40</sup> See Competitive Telecommunications Association Comments at 16; GSA Comments at 6; LDDS Worldcom Comments at 25; MCI Comments at 22-23; Wisconsin PSC Comments at 6.

<sup>41</sup> NPRM at ¶ 77.

As various commenters note, the proposed uniform valuation approach provides several significant advantages over the current rules. Most importantly, uniform valuation of services and assets would assist in enforcing the "arms-length" requirement, by deterring a BOC from procuring services from its separate affiliate at a fully distributed cost that is above market value or selling services to its affiliate at below market value. In the manufacturing area, adoption of such an approach will help to reduce the risk that BOCs will subsidize their manufacturing affiliates by purchasing equipment and related services from these affiliates at above fair market value.<sup>42</sup> Use of a uniform valuation methodology also would eliminate a BOC's incentive to record affiliate transactions as the provision of a service, in order to avoid the more stringent rules applicable to asset transfers, which are designed to prevent BOCs from purchasing from their affiliates at above-market prices.<sup>43</sup>

The BOCs' principal objection to the Commission's proposal is that the fair market value of services is more difficult and/or costly to determine than fair market value for asset transfers.<sup>44</sup> However, the services of greatest concern to TIA

---

<sup>42</sup> See GSA Comments at 6; LDDS Worldcom Comments at 25; MCI Comments at 22-23.

<sup>43</sup> See NPRM at ¶ 78; Telecommunications Resellers Association Comments at 11.

<sup>44</sup> See BellSouth Comments at 32-34; NYNEX Comments at 21-25; USTA Comments at 17-18; U S West Comments at 15-16.

are those typically associated with the sale of equipment (e.g., installation, maintenance, and repair). The fair market value of these types of services generally is readily ascertainable, given the current well-established and highly competitive domestic telecommunications equipment marketplace.

While the Commission previously declined to adopt a uniform valuation approach, in its 1993 Affiliate Transactions Notice, the Commission explained that the rationale for its earlier decision is no longer valid:

The Commission's reason for not applying the asset transfer rules to services was that commenters had suggested that those rules would reduce or eliminate the 'incentive for certain service activities to be provided in a more efficient manner than that which the regulated entity would alone achieve.' We believe that developments since the adoption of the affiliate transactions rules have undermined this rationale. The affiliate transactions rules took effect on April 3, 1987. Since that date, we have adopted price cap regulatory programs that give AT&T and most large LECs efficiency incentives far stronger than those the valuation methods for affiliate services sought to preserve.<sup>45</sup>

Indeed, as the Commission further noted, the Commission's experience with the existing rules "has made clear that, instead of motivating carriers to operate efficiently, the present valuation methods for affiliate services reward imprudent carrier conduct."<sup>46</sup>

---

<sup>45</sup> Affiliate Transactions Notice, supra n.21, at ¶ 31 (citations omitted).

<sup>46</sup> Id. at ¶ 32. See also MCI Comments at 22.

Accordingly, to ensure that BOC manufacturing affiliates do not receive the benefit of anticompetitive cross-subsidies, the Commission should amend its current rules to equalize the treatment of all affiliate transactions, whether they involve asset transfers or the provision of services.

**B. PREVAILING COMPANY PRICES [NPRM Section III.B.1.c.ii.; ¶¶ 80-82]**

TIA also supports the Commission's proposal to eliminate the use of prevailing company prices as a valuation method.<sup>47</sup> Contrary to the claims of certain BOCs,<sup>48</sup> the Commission has provided ample justification for this modification to its existing rules. The Notice indicates that since the affiliate transactions rules were first adopted, the Commission has found that this method is often unreliable (particularly in situations where the percentage of third-party business is small) and can be used to enable a BOC affiliate to charge inflated prices for goods and services sold to its affiliated BOCs.<sup>49</sup> As the Commission has recognized, such behavior results in the provision

---

<sup>47</sup> See NPRM at ¶ 82.

<sup>48</sup> See BellSouth Comments at 27; SBC Comments at 31.

<sup>49</sup> See NPRM at ¶ 81. In its 1993 Affiliate Transactions Notice, the Commission noted that while "[i]n the Joint Cost proceeding, the Commission selected prevailing company prices as a valuation method because it believed that those prices would provide a reasonably reliable measure of fair market value[,] [o]ur experience in applying the rules has failed to substantiate this belief." Affiliate Transactions Notice, supra n.21, at ¶ 16 (citation omitted).

of a subsidy to the BOC affiliate which it can then use to reduce its price, in order to secure sales of equipment or other assets and services to other potential customers, "to the detriment of fair competition."<sup>50</sup>

TIA shares the concerns expressed by the Commission and a number of commenters<sup>51</sup> with regard to the reliability of prevailing company prices. To the extent that the prices which a BOC affiliate charges third-parties may be relevant to the valuation of its affiliate transactions, this information can be considered, along with other factors, in determining the fair market value of the transaction. Indeed, in its Affiliate Transactions Notice, the Commission expressly contemplated such a use for prevailing company pricing information.<sup>52</sup> If

---

<sup>50</sup> See NPRM at ¶ 81. The economic effect of such conduct is the displacement of competing suppliers who may be as efficient or more efficient than the BOC affiliate, as well as an increase in the costs ultimately borne by BOC ratepayers. See e.g., United States v. Western Electric Co., 592 F.Supp. 846, 869, n.93 (D.D.C. 1984) ("[Cross-subsidization] may or may not violate the antitrust laws, but to the extent that the cross-subsidized venture is able to divert sales from its more efficient rivals, it impedes competition."); Peter N. Huber, The Geodesic Network, 1987 Report on Competition in the Telephone Industry (January 1987) at 14.19-20 ("Cross-subsidy . . . is a concern for antitrust purposes because it may permit a less efficient manufacturer to stay in production, displacing more efficient producers that would otherwise prevail in a truly competitive market.").

<sup>51</sup> See, e.g., Competitive Telecommunications Association Comments at 16; Telecommunications Resellers Association Comments at 12.

<sup>52</sup> See Affiliate Transactions Notice, supra n.21, at n. 18.