RECEIVED
AUG - 4 1997
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

**Before the**
**Federal Communications Commission**
**Washington, D.C. 20554**

| | | |
|---|---|---|
| In the Matter of | ) | |
| | ) | |
| Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934 as amended | ) | CC Docket No. 96-149 |
| | ) | |
| and | ) | |
| | ) | |
| Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area | ) | |

# PETITION FOR RECONSIDERATION
# UNITED STATES TELEPHONE ASSOCIATION

Its Attorneys

Mary McDermott
Linda Kent
Keith Townsend
Hance Haney

Todd Colquitt
Director, Legal & Regulatory Affairs

U.S. Telephone Association
1401 H Street, NW, Suite 600
Washington, DC 20005
(202) 326-7249

August 4, 1997

# TABLE OF CONTENTS

## SUMMARY

In its recent order in this proceeding, the Commission unilaterally and without notice modified the requirements of the Competitive Carrier Fifth Report and Order by mandating that the long distance affiliate of an independent ILEC be a "separate legal entity." This action reverses previous Commission treatment of such activity and directly contravenes Congress' intent that such requirements not apply to independent ILECs.

The Commission's concerns about independent ILECs using their local exchange facilities to harm interexchange competition are unfounded. The Commission has had safeguards in place since before passage of the Telecommunications Act of 1996 to prevent discriminatory access and has found them to be successful. Moreover, the overwhelming reliance of ILECs on resale to provide long distance service also precludes discriminatory access.

The Commission's Part 64 cost allocation process is sufficient to deter and detect cross-subsidization. The Commission should take this opportunity to avoid regulatory in favor of non-structural accounting safeguards. There is ample precedent where the Commission previously has chosen to apply existing accounting safeguards rather than structural safeguards. Accordingly, the Commission should direct ILECs offering long distance service to treat such costs as non-regulated for accounting purposes and apply the Part 64 cost allocation procedures.

The Commission's concern about ILECs engaging in price squeezes seems to favor theoretical possibility over practical reality. ILECs cannot raise their access rates with the ease the Commission seems to accord the practice. Moreover, raising access rates would only encourage competitors to bypass the ILEC by purchasing unbundled network elements or engaging in a counter-price squeeze. Additionally, competing IXCs would pass the increased

costs along to the ILEC affiliate reselling long distance service in the form of increased wholesale rates. A possible price squeeze faces hurdles so high as to render it impractical and highly unlikely.

The Commission's heightened concern about independent ILECs harming the long distance market has no basis when viewed against the history of independent ILEC long distance service thus far. There have been no complaints against independent ILECs. Moreover, the unnecessary strengthening of the safeguards runs against the grain of Commission treatment of ILEC provisioning of cellular, PCS, Internet, voicemail, payphones, CPE, and many other activities.

**Before the**
**Federal Communications Commission**
**Washington, D.C. 20554**

| | | |
|---|---|---|
| In the Matter of | ) | |
| | ) | |
| Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934 as amended | ) | CC Docket No. 96-149 |
| | ) | |
| and | ) | |
| | ) | |
| Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area | ) | |

**PETITION FOR RECONSIDERATION**
**UNITED STATES TELEPHONE ASSOCIATION**

Pursuant to Section 1.429 of the Commission's rules, the United States Telephone Association ("USTA") respectfully requests that the Federal Communications Commission reconsider the rules adopted within its Second Report and Order[1] -- and subsequently modified in an Order on Reconsideration executed pursuant to the Commission's own motion[2] -- in the

[1] Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace, Second Report and Order and Third Report and Order, CC Docket Nos. 96-149, 96-61, FCC 97-142 (released April 18, 1997) (Classification of LEC Long Distance Service Report and Order).

[2] Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace, Order on Reconsideration, CC Docket Nos. 96-149, 96-61, FCC 97-229 (released June 27, 1997).

above-captioned proceeding. USTA is the major trade association of the local exchange carrier ("LEC") industry, with over 1,000 members.

## I. Congress Specifically Refrained From Placing Separate Subsidiary Requirements On Independent ILECs Offering Long Distance Service.

When Congress drafted the statutory language of the Telecommunications Act of 1996,[3] it had ample opportunity to consider what safeguards, if any, might be appropriate for incumbent local exchange carriers ("ILECs") offering in-region long distance service. In due course, Congress decided to impose explicit safeguards on the Bell Operating Companies only.[4] Congress' conscious decision not to codify similar requirements for any independent ILEC is indicative of its belief that the imposition of regulatory burdens greater than those already applicable to independent ILECs would cause more harm than good.

This viewpoint is confirmed in a letter to Chairman Hundt dated June 25, 1997 and signed by a number of Members of Congress. In relevant part the letter states that:

> In deliberations over the 1996 Act, Congress decided against imposing a separate affiliate requirement on the mid-sized companies for their provision of long distance and wireless services. We decided to impose a separate affiliate requirement on the largest local telephone companies [i.e., only the BOCs] only after extensive debate and only on the condition that the separate affiliate requirement would sunset three years after any such company is authorized to provide interLATA services unless the Commission extends the period by its own action. The Commission's decision to impose the separate affiliate requirement on mid-sized companies' provision of in-region long distance services does not sunset until further Commission action. This decision by the Commission ignores the

---

3 Telecommunications Act of 1996, Public Law No. 104-104.

4 47 U.S.C. § 272

> rejection by the Congress of the proposal to require separate affiliate for mid-sized companies and actually imposes more severe separate affiliate requirements on them, due to absence of a sunset, than the Commission has imposed on the largest local telephone companies, with respect to which the Congress did decide to require separate affiliates for a limited time. *This result clearly requires reexamination.* (emphasis added)
>
> In addition, the Commission has decided that large long distance companies are not required to establish separate affiliates for their joint offerings of local and long distance telephony. Smaller, independent telephone companies should not be subject to heavier regulatory burdens than are these companies.[5]

Although it references mid-size ILECs, the Congressional intent referred to in this letter clearly applies to <u>all</u> independent ILECs. The Commission was wrong to unilaterally modify its interpretation of the affiliate requirement and impose another regulatory burden on independent ILECs. That decision is clearly contrary to the intent of Congress, which refrained from requiring a separate subsidiary for independent ILEC provision of long distance service. Despite protestations to the contrary,[6] requiring long distance affiliates to be separate legal entities constitutes structural separation. Structural separation is not what Congress intended. The Commission should reconsider its unilateral modification.

---

5 Letter to The Honorable Reed E. Hundt, Chairman, dated June 25, 1997, signed by Representatives Tauzin, Oxley, Boucher *et al.* at p. 2.

6 <u>Classification of LEC Long Distance Service Report and Order</u> at ¶ 165. ("We do not, however, require actual 'structural separation.'") (footnote omitted).

## II. The Commission's Concerns About Independent ILECs Using Their Local Exchange Facilities To Harm Interexchange Competition Are Unfounded.

### A. The Commission's Concern About Independent ILECs Providing Discriminatory Access To Their Long Distance Affiliates Ignores Existing Safeguards And Fails To Take Into Account The Manner In Which ILECs Offer Long Distance Service.[7]

Even before passage of the Telecommunications Act of 1996, the Commission had already established safeguards designed to ensure that ILECs did not discriminate in favor of any interexchange carrier in the provision of access services. In its Equal Access Order, the Commission firmly laid out a timetable for all independent ILECs to convert their switches to equal access and set a standard of non-discrimination.[8] This principle of non-discriminatory access is augmented and strengthened by the statutory language of Section 251 of the Communications Acts of 1934 dealing with local interconnection.

In its Classification of LEC Long Distance Service Report and Order, the Commission states that part of its rationale for strengthening and modifying the Competitive Carrier Fifth Report and Order requirements is to deter discriminatory access favoring the ILEC's affiliate

---

[7] Classification of LEC Long Distance Service Report and Order at ¶ 160. ("[A]n independent LEC, like a BOC, potentially could use its market power in the provision of exchange access service to advantage its interexchange affiliate by discriminating against the affiliate's interexchange competitors with respect to the provision of exchange and exchange access services.")

[8] MTS and WATS Market Structure Phase III, Report and Order, CC Docket No. 78-72, Phase III, 100 FCC 2d 860 (1985) ("Equal Access Order") at p. 875, ¶ 48 .

over its competitors.[9] The Commission's approach here is contrary to the approach it has taken to this same issue in all other contexts. Independent ILECs are not required to conduct any other business through a "separate legal entity". Instead, the Commission relies on the non-structural safeguards of Part 64 for independent ILEC provision of services such as cellular; PCS; Internet; voicemail and other enhanced services; payphones; and CPE among others. In the case of long distance operations, the same approach will more than meet the Commission's concern. This is particularly true in light of the fact that practically all independent ILECs conduct their long distance operations via resale. It is nearly impossible for an ILEC that resells bulk minutes from an interexchange carrier to discriminate against any interexchange carrier without also discriminating against its own resold service. Conversely, an ILEC cannot favor its own affiliated facilities over those of another if it does not own comparable facilities in the first place.

### B. The Commission's Concerns About Independent ILECs Misallocating Costs Can Best Be Addressed Through The Existing Part 64 Mechanisms.[10]

Traditionally, the Commission's concern regarding cross-subsidization has been to prevent an ILEC from subsidizing its non-regulated activities by misallocating such costs to its

[9] Classification of LEC Long Distance Service Report and Order at ¶ 163. ("The prohibition on jointly owned facilities also helps to deter any discrimination in access to the LEC's transmission and switching facilities by requiring the affiliates to follow the same procedures as competing interexchange carriers to obtain access to those facilities.")

[10] Classification of LEC Long Distance Service Report and Order at ¶ 159. ("We believe that, absent appropriate and effective regulation, independent LECs have the ability and incentive to misallocate costs from their in-region, interstate, interexchange services to their monopoly local exchange and exchange access services within their local service region.")

regulated activities. In addition to harming the ratepayers through elevated rates, such cost misallocation also poses a competitive harm to competitors. The Commission established its Part 64 cost allocation rules[11] to deter and detect perceived anti-competitive behavior.[12] These rules are more than sufficient to guard against the possibility of cost-shifting. Placing a burden on independent companies requiring them to form a separate company provides no additional protection.

Almost two-fifths of independent ILECs offering long distance service are average schedule companies.[13] Cost misallocation is not a directly pertinent concern with respect to these companies, nor is there any incentive for these companies to engage in cost misallocation. An average schedule company could conceivably misallocate all of its costs and still accrue no subsequent financial or marketshare advantages.

With respect to the remaining independent ILECs, who, like the average schedule ILECs, are overwhelmingly resellers, cost misallocation becomes relevant only if the non-regulated costs are incorporated into the rate base of the regulated operations, particularly local rates.[14] The

---

[11] 47 C.F.R. Part 64, Subpart I.

[12] Affidavit of Carl R. Geppert ("Geppert Affidavit"), attached, at ¶ 30.

[13] USTA Membership Directory, 1997-1998 (not yet published). Omitting the BOCs, 179 ILECs offer long distance service, of which 69 are average schedule. As of October 1, 1996 there were 658 average schedule companies total, and USTA is aware of a number of these companies that are actively considering offering long distance service. The number of average schedule companies offering long distance service could grow significantly.

[14] Geppert Affidavit at ¶ 43 ("Cross-subsidy only occurs when the costs used to develop prices for regulated services improperly include costs of nonregulated activities.")

Commission can address that concern simply by applying its Part 64 cost allocation rules to separate the costs of interstate long distance operations from other regulated operations of the independent ILEC.

### C. The Commission Should Replace The Competitive Carrier Fifth Report And Order Affiliate Requirements By Simply Applying The Part 64 Cost Allocation Procedures To ILEC-Provisioned Long Distance Service.

The Commission has previously acknowledged a duty to avoid regulatory accretion whenever possible and eliminate out-of-date regulatory requirements whose functions are fulfilled and superseded by more recent changes in the regulatory environment.[15] This is one of those instances. The Commission should reconsider the rules adopted by it in the instant proceeding and reject the mandatory affiliate model (in any form) in favor of one based on Part 64 and nonstructural safeguards. Specifically, USTA requests that the Commission provide that, for *accounting* purposes, any independent ILEC providing in-region, interstate domestic interexchange services or in-region, international interexchange services separate and allocate the costs of such services from the regulated costs of its local exchange operations pursuant to 47 C.F.R. Part 64 Subpart I as if its in-region, interstate domestic interexchange services and in-

---

[15] Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, Fourth Report and Order, CC Docket No. 79-252, 95 FCC 2d 554, (1983) (Competitive Carrier Fourth Report and Order) at p. 580, ¶ 38. ("Generally, the Commission has the duty to determine that its rules promote the public interest when applied to particular carriers or applicants, and to refrain from imposing and to remove unnecessary regulatory burdens on carriers.") (footnote omitted)

region international interexchange services were nonregulated costs.[16]

USTA notes that the treatment of regulated services as non-regulated strictly for accounting purposes is not without precedent at the Commission. Indeed, in the Commission's Accounting Safeguards Order, the Commission affirmed that treating certain regulated services as nonregulated for accounting purposes would provide adequate protection against cross-subsidization.[17] Treating these services as nonregulated for accounting purposes would not impose extensive costs on independent ILECs.[18]

ILECs are presently required by the Commission's rules to maintain "arm's length" relations between it and its affiliate. The affiliate is required, just like every other competing interexchange carrier, to take tariffed exchange access services at tariffed rates. Therefore, an

---

16 USTA has attached a complete set of suggested rules as an alternative to the Commission's in Appendix A of this Petition.

17 Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, Report and Order, CC Docket No. 96-150, FCC 96-490 (released December 24, 1996) (Accounting Safeguards Order) at ¶ 75. ("For these reasons, we agree with TRA, GSA, and AT&T that under our current cost allocation rules we can most efficiently and comprehensively satisfy sections 254(k) and 271(h) if, solely for federal accounting purposes, we treat like nonregulated activities both out-of-region and certain types of incidental interLATA services that may be provided by incumbent local exchange carriers on an integrated basis. *We believe that this should sufficiently safeguard against cross-subsidization without imposing additional accounting requirements on carriers.*") (emphasis added)

18 See Geppert Affidavit at ¶¶ 49-50. The Commission also apparently agrees with this assessment. See, e.g. Accounting Safeguards Order at ¶ 75. ("Because incumbent local exchange carriers currently have internal accounting systems in place to allocate costs fairly between nonregulated activities and regulated services provided on an integrated basis, such a requirement will not impose extensive expense upon incumbent local exchange carriers.")

ILEC affiliate cannot receive preferential treatment.[19] Treating interexchange services as non-regulated for accounting purposes and applying the Part 64 cost allocation rules as suggested by USTA would maintain the same "arm's length" relationship between the exchange access and long distance operations, with access charges being imputed to the long distance business. The Commission should reconsider the rules adopted in its Classification of LEC Long Distance Service Report and Order in favor of USTA's suggested Part 64 approach.

**D. The Commission's Concern About Independent ILECs Initiating Price Squeezes Is Flawed Because Its Ignores The Significant Practical Difficulties That Implementing Such A Squeeze Would Necessarily Entail.[20]**

The Commission's concern about a price squeeze revolves around the scenario in which the ILEC increases its access charges to interexchange carriers ("IXCs"). The IXCs then face two choices. They can increase their retail rates to maintain their profit margins, but at the risk of losing market share to the ILEC interexchange affiliate. Or, the IXCs can maintain their present retail rates, but at the cost of seeing their profit margins cut.[21] (The Commission further assumes that the ILEC affiliate similarly retains its present rates.) The Commission's reasoning is flawed on both counts.

---

[19] See, also, Geppert Affidavit at p. 10, ¶ 25.

[20] Classification of LEC Long Distance Service Report and Order at ¶ 161. ("We are also concerned that an independent LEC could potentially initiate a price squeeze to gain additional market share.")

[21] Classification of LEC Long Distance Service Report and Order at ¶ 161.

For this theoretical result to become reality, three unlikely things must happen: 1) the regulatory process for setting ILEC access rates must fail; 2) if there is an interconnection agreement, the competitor must fail to bypass the ILEC by purchasing unbundled network elements; and, 3) the IXC underlying the ILEC affiliate's resold service fails to pass along its increased costs in its wholesale rates.

The Commission's Order seems to assume that ILECs are able to raise access charges arbitrarily and without any regulatory oversight. The overwhelming number of ILECs offering long distance service operate under rate-of-return regulation. These companies have minimal discretion in changing their tariffed access charges without regulatory approval. Even those few independent ILECs operating under price cap regulation and streamlined tariffing have severely limited discretion in changing their tariffed access charges. Thus, it is highly unlikely that an ILEC would be able to raise its access rates in an attempted price squeeze in the first place.

Assuming *arguendo* that an ILEC was able to circumvent regulatory oversight, the attempted price squeeze would not work in the case where the ILEC had an interconnection agreement. Through the interconnection agreement, the competitor would be able to bypass the ILEC's increased access rates by purchasing unbundled network elements. Moreover, the competitor could respond to a price squeeze by engaging in one of its own. Any theoretical gain in ILEC marketshare would be negated by that of the competitor's price squeeze. Again, it is highly unlikely that a competitor would permit an ILEC to attempt a price squeeze without bypassing the ILEC completely or responding in similar fashion.

Finally, if the ILEC affiliate is a reseller -- which is nearly always the case -- then the price squeeze scenario hurts the affiliate even more. The retail rates of resellers depend on the wholesale rates charged by the underlying IXC. These wholesale rates in turn depend in part on the access charges levied by the ILEC. If an ILEC raises access charges in an attempted price squeeze, the IXC's increased costs will be reflected in its wholesale rates. Thus, the increased access rates will boomerang back against the ILEC affiliate. The Commission has already recognized the validity of this statement.[22]

The ILEC has no incentive to raise access charges in the hopes that doing so will reduce the profit margins of its competitors. Although the price squeeze is an interesting exercise in economic theory, putting theory into practice would require all regulatory and market safeguards to fail. The ILEC would first have to succeed in gaining approval for increased access rates from the regulators amid opposition from the IXCs. In the marketplace, the ILEC affiliate's competitors would have to possess an amazing lack of business acumen to permit the ILEC to increase access rates without bypassing the ILEC altogether, responding with a similar price squeeze, or passing the increased costs along in the wholesale rates charged to the ILEC affiliate.

## III. There Is No Basis For The Commission's Unfounded Concerns About Independent ILECs Causing Harm To The Long Distance Market.

USTA is uncertain as to what might be the source of the Commission's concerns about

---

[22] Competitive Carrier Fourth Report and Order at p. 577, ¶ 35. ("We distinguished resellers from other non-dominant carriers in that resellers do not own their own facilities; the underlying carriers' rates act as a "just and reasonable" ceiling on resellers' rates, and resellers cannot affect the availability to the public of services via underlying facilities.") (footnote omitted)

independent ILECs harming the long distance market. Independent ILECs have been offering long distance service for many years. In its Competitive Carrier Fifth Report and Order, the Commission specifically acknowledged that independent ILECs had not engaged in anti-competitive behavior.[23] Similarly, in the time since the Competitive Carrier Fifth Report and Order was released, the Commission has not perceived any anti-competitive behavior by independent ILEC interexchange affiliates.[24] In light of its own statements, the Commission's decision not only to retain but to *strengthen* the Competitive Carrier Fifth Report and Order requirements is perplexing and contrary to the evidence in this record.

The service regions of independent ILECs are small and generally do not traverse LATA boundaries.[25] Moreover, the service territories of most independent ILECs are so small that end-to-end provision of long distance service is not possible because calls originating and terminating within the region do not travel far enough to qualify as long distance. The Commission does not

---

[23] Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, Fifth Report and Order, CC Docket No. 79-252, 98 FCC 2d 1191, (1984) (Competitive Carrier Fifth Report and Order) at ¶ 7. ("We have received no petitions opposing the tariffs of interexchange carriers affiliated with exchange telephone companies since the *Fourth Report*, and the only formal complaint filed against an affiliated interexchange carrier concerns billing for calls after five rings even though the calls are not completed.") (footnote omitted).

[24] Classification of LEC Long Distance Service Report and Order at ¶ 165. ("[I]ndependent LECs have been providing in-region, interstate, interexchange services on a separated basis with no substantiated complaints of denial of access or discrimination. The Fifth Report and Order separation requirements have been in place for over ten years.")

[25] See *infra* at Section V for further discussion.

dispute this.[26] Furthermore, even for traffic originating within their own service regions, the amount of long distance traffic carried by ILEC affiliates is but a small fraction of the total volume of traffic, the vast bulk of which is carried by the large IXCs. This, coupled with the continuous good faith behavior exhibited by the independent ILECs and their affiliates deprives the Commission of any cause to impose increased regulatory burdens.

## IV. The Commission's Newly Adopted Requirement That An ILEC's Long Distance Affiliate Be A Separate Legal Entity Is An Unwarranted Departure From Previous Commission Policy, Was Not Proposed In The Notice Of Proposed Rulemaking And, Thus, Is Not Supported By The Record.

In the Commission's Competitive Carrier Fifth Report and Order, the Commission enumerated the safeguards it deemed necessary to address its concerns about cost-shifting and anti-competitive conduct by independent ILECs offering non-dominant long distance service. Specifically, the Commission stated that independent ILECs were required to provide such service through an affiliate that: 1) maintained separate books of account; 2) did not jointly own or control any switching or transmission facilities; and 3) acquired exchange company tariffed services at tariffed rates.[27] The Commission's Competitive Carrier Fifth Report and Order

---

[26] Classification of LEC Long Distance Service Report and Order at ¶ 170. ("Independent LECs tend to be more geographically dispersed and their service territories are largely rural in nature, therefore, they generally serve areas that are less densely populated than BOC service areas. In addition, because the services areas of independent LECs tend to be smaller than the service areas of BOCs, on average, independent LECs have fewer access lines per switch than BOCs and provide relatively little interexchange traffic that both originates and terminates in their region.") (footnote omitted).

[27] Competitive Carrier Fifth Report and Order, p. 1198, ¶ 9.

definition of "affiliate" specifies that the affiliate does not need to be a separate legal entity.[28]

Specifically, the Commission stated that:

> We have not required structural separation for the other exchange telephone companies' CPE activities and enhanced services. For these exchange telephone companies, our treatment of their nondominant interstate, interexchange services would be similar to our treatment of their CPE activities and enhanced services, primarily separate books of account but not structural separation..." *et seq.*[29]

In its recent order, the Commission --unilaterally and without notice --modified the requirements of the Competitive Carrier Fifth Report and Order and mandated that the independent ILEC affiliate be a "separate legal entity".[30] Again, USTA urges the Commission to reconsider this modification. This new "separate legal entity" requirement is burdensome to independent LECs and is contrary to the regime that has applied to these companies for over a

---

[28] Competitive Carrier Fifth Report and Order, p. 1198, ¶ 9. ("A carrier affiliated with an exchange telephone company is a carrier that is owned (in whole or part) or controlled by, or under common ownership (in whole or part) or control with, an exchange telephone company.")

[29] Competitive Carrier Fifth Report and Order, p. 1198, ¶ 9, footnote 23.

[30] In the Classification of LEC Long Distance Service Report and Order, the Commission makes the statement at ¶ 165 that "[a]s... stated in the Interim BOC Out-of-Region Order, the separation requirements of the Fifth Report and Order require that the LEC interexchange affiliate be a separate legal entity." The Interim BOC Out-of-Region Order does indeed make this distinction in ¶ 22. However, examination of the Commission's Notice of Proposed Rulemaking in that proceeding reveals that nowhere does the Commission suggest, much less propose, that the affiliate requirement entails legal separation. Examination of the comments and replies in that proceeding similarly fail to provide a record of consideration on the issue of whether the affiliate needs to be a separate legal entity. Though some commenting parties (e.g., CompTel at p. 8) argue for the adoption of strict structural separation, the Commission rejected those arguments in favor of applying the Competitive Carrier Fifth Report and Order affiliate requirements to BOC interexchange affiliates.

decade and that has functioned without complaint. Most important, the modification is completely unnecessary to satisfy the Commission's goals. USTA urges the Commission not only to eliminate this "separate legal entity" requirement but to explicitly rely on the non-structural accounting safeguards it has developed and perfected in the years since issuing the Competitive Carrier Fifth Report and Order..

The Commission failed to propose such a modified interpretation in the Notice of Proposed Rulemaking precipitating the Classification of LEC Long Distance Service Report and Order.[31] *Prima facie* evidence of this failure is contained in the Commission's own citation within the Classification of LEC Long Distance Service Report and Order. Instead of referencing the precipitating Non-Accounting Safeguards NPRM, it references the Interim BOC Out-of-Region Order, an entirely separate proceeding having no direct bearing on the matter at hand. Moreover, this unrelated proceeding itself failed to properly provide a proposal to modify the affiliate interpretation in the precipitating Interim BOC Out-of-Region NPRM. In short, the Commission's decision to unilaterally modify its interpretation of the term "affiliate" with respect to independent LECs offering long distance service is unsupported by either the record or the Non-Accounting Safeguards NPRM.

---

[31] Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended; and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area, Notice of Proposed Rulemaking, CC Docket No. 96-149, FCC 96-308 (released July 18, 1996) (Non-Accounting Safeguards NPRM).

## V. The Commission Should Clarify The Distinction Between InterLATA Traffic And Interexchange Traffic To Avoid The Improper Application Of Affiliate Safeguards.

As a final note, the Commission should clarify the distinction between interLATA long distance service and interexchange long distance service. A LATA is a construct resulting from the divestiture of AT&T and applies solely to the Bell Operating Companies. An exchange area, though similar in concept to a LATA, applies to independent ILECs. It is possible for independent ILEC interexchange traffic to be intraLATA with respect to BOC service regions. The Commission's Order uses the terms "interLATA" and "interexchange" interchangeably. This raises the potential for confusion and the inappropriate application of the affiliate safeguards on services to which they were never previously applied. Accordingly, the Commission should clarify the distinction.

## CONCLUSION

The changing regulatory environment is one toward less regulation for every segment of the telecommunications industry, except apparently for independent ILECs and their affiliates. It is not sound public policy that independent ILECs are required to provide long distance service through legally separate affiliates, whereas global service providers like AT&T and MCI are not similarly burdened when offering integrated local and long distance service. Nor is it sound public policy that independent ILECs are required to provide long distance service through legally separate companies without any sunset date beyond that of the Commission's pleasure, whereas the BOCs' affiliate requirements sunset after three years. For this and the above-stated reasons, the Commission should reconsider the rules adopted by it in its Classification of LEC Long Distance Service Report and Order in favor of those proposed by USTA.

Respectfully submitted,

UNITED STATES TELEPHONE ASSOCIATION

BY Mary McDermott

Its Attorneys

Mary McDermott
Linda Kent
Keith Townsend
Hance Haney

Todd Colquitt, Director
Legal & Regulatory Affairs

U.S. Telephone Association
1401 H Street, NW, Suite 600
Washington, DC 20005
(202) 326-7249

August 4, 1997

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

| | | |
|---|---|---|
| In the Matter of | ) | |
| | ) | |
| Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended. | ) | CC Docket No. 96-149 |
| | ) | |
| Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area | ) | |

## AFFIDAVIT OF CARL R. GEPPERT

I, CARL R. GEPPERT, being first duly sworn, do hereby state that:

1. I am a Certified Public Accountant and a partner of Arthur Andersen. My business address is 1225 17th Street, Suite 3100, Denver, Colorado 80202. Andersen Worldwide, with over 100,000 people, provides professional services to clients through member firms in 361 locations in 76 countries. It consists of Arthur Andersen for audit, tax, business advisory and specialty consulting services and Andersen Consulting for global management and technology consulting. I am a member of a group at Arthur Andersen that provides audit, tax and consulting services to clients in the communications industry.

2. During my 17-year career, I have been almost exclusively involved in financial, regulatory and cost accounting matters in the telecommunications and utilities industries. I have served as an auditor for and consultant to clients in the telecommunications industry and

3. Of particular relevance to this proceeding is my extensive experience with the FCC's accounting safeguards. I actively participated in the rulemaking proceedings adopting those safeguards and as a consultant, I have subsequently designed systems and procedures to implement the FCC's accounting safeguards. I currently direct our Firm's audit and consulting activities with respect to local exchange carrier compliance with such rules and regulations. Finally, I have submitted expert evidence concerning accounting safeguards and related subjects in connection with proceedings before the FCC and state regulatory commissions.

**PURPOSE AND CONCLUSION OF AFFIDAVIT**

4. By this petition, the USTA seeks Commission reconsideration of the rules adopted within its Second Report and Order in the above-captioned proceedings. Should USTA's petition be granted, existing FCC accounting safeguards will be sufficient to prevent the incumbent independent local exchange carriers (ILECs) from pricing their regulated local exchange and exchange access services in a manner which could result in subsidies to in-region interLATA long-distance service offerings.

5. My affidavit will explain that the necessary FCC accounting safeguards are already in place and have been operating effectively since 1988. Specifically, I will:

- Describe the FCC's integrated system of accounting safeguards and related oversight and enforcement mechanisms with an emphasis on the affiliate transaction rules.

- Explain why the accounting safeguards are adequate to prevent the ILECs from engaging in cross-subsidy and are operating effectively.

- Discuss how the accounting safeguards have been continuously fine-tuned and strengthened since they were first adopted.

- Discuss how the FCC's accounting safeguards would apply to the ILECs' provision of in-region long distance services pursuant to USTA's petition for reconsideration (PFR).

6. I conclude overall that the FCC's accounting safeguards are an effective tool to ensure that ILEC regulated local exchange and exchange access services will not subsidize in-region interLATA long-distance services should USTA's petition be granted.

**DESCRIPTION OF THE FCC'S ACCOUNTING SAFEGUARDS**

7. During the past decade, the FCC has adopted a series of new accounting and cost allocation rules and substantially modified other long-standing accounting and cost allocation rules. These rules collectively ensure that the costs of nonregulated or competitive activities are not improperly borne by regulated services. Indeed, the FCC's rules dictate that nonregulated services bear a proportionate amount of the joint and common costs (i.e., common overhead) that regulated services would otherwise bear in full. Pursuant to USTA's petition, ILEC in-region interLATA long-distance services would be treated as a "nonregulated activity" for the purpose of applying these rules. Throughout the remainder of my affidavit, I will refer to ILEC in-region interLATA long-distance service as a nonregulated service. I will discuss the specifics of this regulatory accounting treatment in greater detail in a later section of my affidavit.

8. The FCC's accounting and cost allocation safeguards follow a logical sequence for identifying and isolating costs of nonregulated activities so that they are properly excluded from the costs upon which prices of regulated services have been or are based. The diagram on the following page depicts the sequence of these processes.