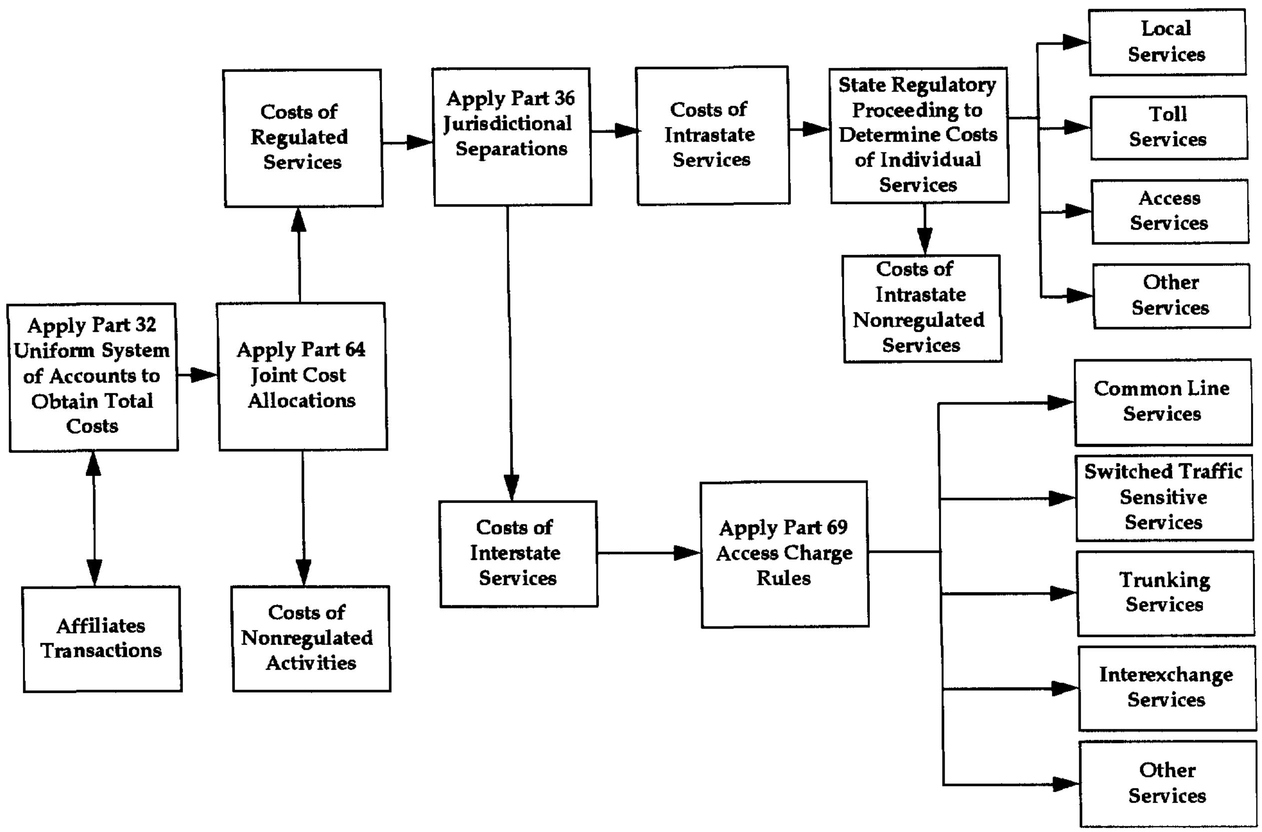
Sequence of FCC Accounting Safeguards



Each step in the sequence of the FCC's system of accounting safeguards is described briefly below.

9. Uniform System of Accounts (USOA) - The FCC's Part 32 rules[1] which were comprehensively revised and updated effective January 1, 1988, prescribe uniform financial accounts and detailed instructions for use by all local exchange carriers. The USOA provides standardized accounting and reporting of financial transactions on a total company level with sufficient cost accounting information to facilitate subsequent cost allocation processes.

10. Affiliate Transactions - Section 32.27 of the USOA, which also became effective on January 1, 1988, provides specific standards governing transactions between regulated carriers and

[1] 47 C.F.R. § 32 et seq. (1996).

their nonregulated affiliates. Services offered by regulated carriers to customers under Federal or state tariffs are charged to nonregulated affiliates at the same tariff rates. For transactions other than tariffed services, if there are substantial sales to unaffiliated third parties (greater than 50% of the revenues from such products of services are derived from third parties), the prevailing prices for those products or services are also used to value like transactions with affiliates. If prevailing prices do not exist, transactions are recorded at the fully distributed cost of the entity that provides a service or transfers an asset to an affiliate. As recently modified by the FCC's Accounting Safeguards Order[2], services provided/assets transferred **by** regulated carriers to nonregulated affiliates are recorded at the **higher** of net book cost or fair market value. Services provided/assets transferred **to** regulated carriers from nonregulated affiliates are recorded at the **lower** of net book cost or fair market value. In the case of services only, nonregulated affiliates that exist solely to provide services to members of the affiliate group are exempt from the above fair market value requirements and are required to follow the fully distributed cost standard only.

11. Joint Cost Allocations - The FCC's rules under Part 64[3] set standards for allocating a regulated carrier's total costs recorded in conformity with the USOA between two aggregate categories: regulated services and nonregulated activities. The joint cost allocation rules reflect fully distributed cost principles with an emphasis on direct assignment and causal attribution of costs. ILECs meeting the FCC's threshold of $100 million in annual operating revenues, as adjusted for inflation, maintain an FCC-approved cost allocation manual that describes procedures for implementing the joint cost allocation rules that also first became effective January 1, 1988.

12. Jurisdictional Separations - Once the costs of nonregulated activities are identified and removed via joint cost allocations, the FCC's Part 36 rules[4] specify how the resulting regulated costs are allocated between the interstate and intrastate regulatory jurisdictions.

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[2] *Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, CC Docket No. 96-150, FCC 96-490 (rel. December 24, 1996), [hereinafter Accounting Safeguards Order].

[3] 47 C.F.R. § 64 et seq. (1996).

[4] 47 C.F.R. § 36 et seq. (1996).

These rules were comprehensively revised and simplified by the FCC effective January 1, 1988.

13. Access Charges - Regulated interstate costs identified through jurisdictional separations are next apportioned among the various rate categories for interstate services. The FCC's access charge rules under Part 69 were initially implemented on January 1, 1984.[5] The access charge rules have subsequently been modified to incorporate "price cap" regulation and various FCC decisions addressing competition in the marketplace for interstate access services, most recently in the FCC's Access Charge Order.[6]

14. State Regulatory Proceedings - The costs allocated to intrastate operations under jurisdictional separations are subject to a wide array of ratemaking processes to arrive at the rates for regulated intrastate services. Almost every state regulatory commission utilizes the FCC's USOA, joint cost allocation and jurisdictional separations rules as the starting point for its own ratemaking process. For the most part, state regulators implicitly accept the FCC accounting safeguards for their intended purposes. Even where state regulators have had an inclination to develop their own accounting safeguards, the practice has been to modify the FCC model rather than reinvent the wheel. Traditionally, state regulatory commissions required cost of service and rate design studies to establish prices for individual intrastate services. Today, various alternative forms of regulation are in effect in most state jurisdictions. A common feature of alternative forms of regulation is a shift away from detailed cost of service/rate of return methodologies to more simplified regulation of the prices of regulated services.

15. Although each of the FCC's rules play a significant role in the accounting safeguards program, the affiliate transaction and joint cost allocation rules are the most relevant and important with respect to preventing cross-subsidy of in-region interLATA long distance services. I will therefore discuss these requirements in greater detail in the next sections of my affidavit.

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[5] 47 C.F.R. §69 et seq. (1996).

[6] *Access Charge Reform*, CC Docket No. 96-262, First Report and Order, FCC 97-158 (rel. May 16, 1997).

Joint Cost Allocations

16. The FCC stated that its purpose in adopting the joint cost allocation rules was "to ensure that ratepayers in the interstate jurisdiction pay telephone rates that are just and reasonable."[7] In that context, the FCC noted that "insuring just and reasonable rates for services that remain subject to regulation requires guarding against cross-subsidy of nonregulated ventures by regulated services, and that cross-subsidy can result either from the misallocation of common costs or from improper intracorporate transfer pricing."

17. To address the misallocation of common costs, the FCC adopted the Part 64 joint cost allocation rules effective January 1, 1988. The Part 64 rules were the product of extensive comment and debate. Ultimately, the FCC defined two broad categories for purposes of applying joint cost allocations. "Regulated services" are either telecommunications services subject to a Federal or state tariff, services that have been detariffed in the state jurisdiction only or incidental non-tariffed activities. "Nonregulated activities" are those products or services which have either never been subject to a Federal or state tariff (for example, real estate leasing) or those which have been preemptively detariffed by the FCC.

18. The list of services preemptively detariffed by the FCC is currently short, consisting of: customer premises equipment sales and service, inside wire installation and maintenance, and enhanced (i.e., information) services. In order for ILEC in-region long distance services to be offered absent a separate subsidiary pursuant to USTA's petition, such long-distance services would need to be treated as a nonregulated activity for purposes of applying the joint cost allocation rules. To the extent that the ILECs engage in cost-based transactions with their long distance operations, the joint cost allocation rules define how fully distributed cost is to be computed.

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[7] *Separation of Costs of Regulated Telephone Services from Costs of Nonregulated Activities*, CC Docket No. 86-111, 2 FCC Rcd 1298 (1987) ¶ 33, [hereinafter Joint Cost Order.]

19. In summary, the joint cost allocation rules under Section 64.901 require that:

- Whenever a nonregulated activity uses a tariffed service, it is to be charged the tariff rate.

- All costs incurred exclusively for either regulated services or nonregulated activities are to be directly assigned to the respective categories.

- Shared costs are to be attributed to the maximum extent possible between regulated services and nonregulated activities based on direct measures of cost causation, if available, or indirect measures.

- Residual costs, for which no direct or indirect measure of cost causation exists, are to be generally allocated between regulated services and nonregulated activities. The general allocator is based on the relative amounts of expenses that can be directly assigned and directly or indirectly attributed to regulated services and nonregulated activities.

Affiliate Transactions

20. The USOA contains specific FCC rules that address transactions between affiliated companies.[8] The affiliate transaction rules apply to services provided and assets transferred in either direction between regulated carriers and their nonregulated affiliates. These rules also apply in cases where nonregulated activities are conducted within the regulated telephone company legal entity, provided that the nonregulated activity does not involve the common or joint use of assets and resources in the provision of both regulated and nonregulated products and services and a separate set of books are used to account for the nonregulated activity.

21. First and foremost, the FCC's affiliate transaction rules are designed to protect customers of regulated services from subsidizing nonregulated activities (whether such activities are conducted within the telephone company or via a separate subsidiary). In fact, the

[8] 47 C.F.R. § 32.27 (1996).

standards adopted by the FCC favor regulated operations and may discourage transactions with nonregulated affiliates/activities. The FCC itself acknowledged this when it observed that "If our rules have an adverse effect on potential transactions [with affiliates], we believe that, on balance, prevention of cost shifting is the more important goal."[9]

22. The bias in favor of regulated services can be seen in the following illustrative application of the affiliate transaction asset transfer rules. Assume there are two identical buildings, one is owned by an ILEC (a regulated carrier) and the other by a nonregulated affiliate or division of the ILEC. If the regulated ILEC transferred its building to the affiliate, under the FCC's affiliate transaction rules, it would record the transaction at the **higher** of the building's net book cost or its fair market value. Assuming that the fair market value is ***higher*** than the depreciated net book value of the building on the regulated ILEC's books, the resulting gain realized upon transfer of the building would usually accrue to the benefit of the ILEC's customers of regulated services. On the other hand, if the affiliate/division transferred an identical building to the regulated ILEC, the ILEC could record only the ***lower*** of the affiliate's net book cost for the building or its fair market value. The asset transfer rules present a "heads I win, tails you lose" proposition for customers of the ILEC's regulated services.

23. Pursuant to the FCC's Accounting Safeguards Order, the above asymmetrical affiliate transaction rules also apply to services provided between regulated carriers and their nonregulated affiliates effective July 21, 1997. This modification to the accounting safeguards further minimizes the risk of cross-subsidization.

24. It has been my experience in practice that the affiliate transaction asset transfer rules at times act as an economic deterrent to asset transfers, particularly those from regulated carriers to nonregulated affiliates. For a regulated carrier, the net book cost of a depreciable asset is often higher than its fair market value, in part because of regulatory depreciation practices. Since transfers of assets to nonregulated affiliates must take place at this higher net book cost, nonregulated affiliates instead purchase assets from an unaffiliated party at

[9] *Joint Cost Reconsideration Order*, CC Docket No. 86-111, 2 FCC Rcd, 6283, (1987) at 6296

lower fair market values. While one can question the economic efficiency of this result, there is little doubt that the rules protect the customers of the regulated carrier in all cases consistent with the FCC's intent.

25. An important provision of the affiliate transaction rules to USTA's petition, the requirement that services be charged to nonregulated affiliates/activities at tariff rates whenever applicable, provides another compelling reason to permit ILECs to provide in-region, interLATA long distance services without requiring a separate affiliate. The ILECs' in-region long distance operations will require local exchange access from the regulated ILEC to originate and terminate long distance calls. Under the affiliate transaction rules, the charges for such access will be based on applicable interstate or intrastate access charge tariff rates, the same reasonable, non-discriminatory rates paid by unaffiliated interexchange carriers. The use of tariff rates ensures that the ILECs' long distance operations will have no advantage over competitors with respect to the prices paid for local exchange access which is the most significant cost component of the long distance business. In addition, the use of tariff rates avoids the complexities of cost allocation and facilitates regulatory monitoring of such affiliate transactions.

26. For non-tariffed services, the FCC affiliate transaction rules for products or services restrict the use of "prevailing prices" between affiliates to only those cases where it can be demonstrated that the same products and services provided to affiliates are sold in substantial quantities to unaffiliated third parties. As defined in the Accounting Safeguards Order, third party sales of specific products and services must account for more than 50% of total sales of such products and services in order for affiliate transactions involving those same products or services to be accounted for at prevailing price. If that is not the case, even if market prices are readily determinable from other sources, the fully distributed cost of the entity providing the product or service must be used. Fully distributed cost consists of direct and allocated indirect expenses associated with the product or service provided to the affiliate plus a return on direct and allocated indirect net investment. The return is limited to that allowed by the FCC for regulated services, currently 11.25%.

27. An example of how prevailing prices may apply to the ILECs' in-region long distance operations is in the area of customer billing and collections. Most likely, ILECs will choose

to include interLATA long distance charges on its customers' bills for local service. The FCC detariffed interstate billing and collection services in 1987, and most state regulatory commissions have similarly detariffed intrastate billing and collection services. In these circumstances, there is no tariff rate that the ILEC can use to charge its long distance operations for performing billing and collection services on its behalf. However, the ILECs do have negotiated contracts with unaffiliated interexchange carriers to provide billing and collection for their long distance services. The rates charged to these unaffiliated customers, if deemed to be substantial in volume, could establish the prevailing price for billing and collection services to be charged by the ILEC to its long distance division. Again, the ILEC long distance operation receives no preferential pricing compared to competitors.

28. If tariff rates or prevailing prices do not exist or apply, services provided from the regulated ILEC to its nonregulated affiliates/activities are recorded at *higher* of fully distributed cost or fair market value while services provided to the regulated ILEC are recorded at the lower of fully distributed cost or market. Fully distributed cost is based on the joint cost allocation standards discussed in the previous section of my affidavit. An example of an affiliate transaction that would be recorded at fully distributed cost is when an attorney from an ILEC provides legal services to the ILEC's in-region long distance division. Unless the ILEC also provided the same legal services to unaffiliated parties in substantial quantities which established a prevailing price for such services, fully distributed cost would be used to charge the long distance operation for the legal services.

29. Fully distributed cost would usually be determined by first measuring the time spent by the attorney to provide the specified legal services to the long distance division. The attorney's hours are then multiplied by a "fully loaded" hourly labor rate which includes not only the attorney's salary and benefits, but also a pro-rata share of the costs of the infrastructure that supports the attorney (e.g., paralegal assistants, the law library, office furniture and equipment and buildings) as well as an allocation of corporate overhead. In my experience, these loadings typically increase direct labor rates by between 50% and 100%. In the following section on joint cost allocations, I will explain why the use of fully distributed cost benefits regulated services.

Oversight and Enforcement Mechanisms

30. In addition to the accounting safeguards themselves, the FCC has instituted a number of oversight and enforcement mechanisms. While the accounting and cost allocation rules I previously described are designed to *prevent* cross-subsidization, the oversight and enforcement mechanisms discussed below are intended to *detect* instances of cross-subsidization should they occur.

Cost Allocation Manuals

31. In order to ensure that the joint cost allocation rules are properly applied, the FCC required carriers to prepare cost allocation manuals detailing how they intended to implement the standards. Tier 1 carriers (those with greater than $100 million in annual operating revenues, as adjusted for inflation) were required to file and obtain FCC approval of their cost allocation manuals. Cost allocation manuals filed with the FCC must contain the following information:

- ❑ Descriptions of each of the nonregulated activities the carrier offers.
- ❑ A chart showing the relationship of the carrier and all of its corporate affiliates.
- ❑ A listing and description of the nature, terms and frequency of transactions between the regulated carrier and each nonregulated affiliate.
- ❑ A listing of incidental regulated activities and the justification for such treatment.
- ❑ Identification of the homogenous cost categories (cost pools) within each Part 32 account and the basis for apportionment between regulated services and nonregulated activities.
- ❑ A description of time reporting techniques used to apportion costs and the internal accounting controls utilized for such processes.

32. The cost allocation manual of each tier 1 carrier was subjected to extensive public comment and thorough staff review. In each case the FCC ordered detailed revisions and subsequently approved a revised cost allocation manual. On average, the tier 1 carrier cost allocation manuals consist of approximately 150 to 200 pages supported by even more detailed internal methods and procedures documentation for implementation purposes.

33. Cost allocation manuals must be regularly updated for changes. Established FCC procedures, including public notice and comment, exist for review and approval of such revisions.

34. In 1993, the FCC ordered local exchange carriers to amend their cost allocation manuals to reflect standardized cost pools and apportionment methods for ten Part 32 accounts. This directive was in response to a previously stated FCC objective "to obtain greater uniformity in LEC cost allocation practices, and to promulgate uniformity requirements."[10]

Reporting

35. The FCC has imposed numerous reporting requirements related to the accounting safeguards. These reports are used by the FCC for various review and monitoring functions and are also made available to the general public.

36. In 1988, the FCC implemented a new, integrated reporting system known as the Automated Reporting and Management Information System (ARMIS). ARMIS reports, filed in both hard copy and diskette format, provide the sequential results of the interstate regulatory process culminating in a presentation of the actual earned rate of return for each interstate access charge category. Specifically, ARMIS reports contain aggregated data on a quarterly and full year basis reflecting the results of the accounting and cost allocation requirements prescribed in Parts 32 and 64 of the FCC's rules as well as the results of jurisdictional separations (Part 36) and access charges (Part 69). All tier 1 carriers are

[10] *Computer III Remand Proceeding: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards*, CC Docket No. 90-623, 6 FCC Rcd 7571, (1991) at 7584-85.

required to file these ARMIS reports annually with the Commission displaying the above information together with additional financial, operational and statistical data.

Independent Audits

37. In developing enforcement mechanisms for joint cost allocations, the FCC concluded that independent audits could be used to supplement the audits performed by its own staff. Each year, an independent public accounting firm must render an opinion as to whether each tier 1 carrier's results reported in the ARMIS Report 43-03, ARMIS Joint Cost Report, are fairly presented in all material respects in relation to their FCC-approved cost allocation manual and the applicable joint cost allocation rules and regulations. Compliance with the affiliate transaction rules is one of the major focus areas of independent audits.

38. Each independent audit involves thousands of hours of work by the independent public accounting firm. In addition, the FCC audit staff reviews the independent auditors' workpapers and performs additional tests. In this way, the FCC staff is able to most effectively utilize its own resources by, in effect, "auditing the auditors." Independent audits are used to identify specific areas where additional audit work will be performed directly by the FCC staff. In some cases, state regulatory commission staffs also review the independent auditors' work and perform audits of their own.

ADEQUACY OF THE ACCOUNTING SAFEGUARDS

39. The FCC's accounting safeguards have been designed specifically to prevent regulated services from subsidizing nonregulated activities. The combined joint cost allocation and affiliate transaction rules protect customers of regulated services from cross-subsidization regardless of how each ILEC engages in nonregulated activities. If the ILECs are able to offer in-region long distance services directly without a separate affiliate, the Part 64 joint cost allocation rules in conjunction with the affiliate transaction rules ensure that the costs of such nonregulated activities are properly separated from the costs of regulated services.

40. The FCC chose an historical, fully distributed cost approach for apportioning costs between regulated services and nonregulated activities. Under the fully distributed cost

methodology, all of the costs of a company are apportioned between categories, either on a causal basis, if identifiable, or some other indirect basis of allocation. The FCC appeared to fully appreciate that its joint cost allocation rules apportion more costs to nonregulated activities than required to prevent cross-subsidy.

> We affirm our intention ... to build our cost allocation scheme upon the premise of full allocation of costs. The reason for this is not that we deem full allocation to be synonymous with prevention of cross-subsidy. In fact, we do not entirely disagree with the parties who observe that cross-subsidy could, in theory, be avoided when all of the long run incremental costs of an activity are borne by that activity. [Footnote omitted.] However, we also agree with DOJ and others who argue that our purposes should transcend prevention of cross-subsidy. Our goal of just and reasonable treatment of ratepayers requires that ratepayers participate in the economies of scale and scope which we believe can be achieved through integration of nonregulated enhanced services within the basic service network. It would not be just and reasonable to allow all of those economies to belong to the nonregulated activities. We also agree with DOJ that there is no good reason why all residual costs of the company should fall to the regulated sector. By the same token, we also disagree with the consumer advocates who seem to argue that all residual costs should fall upon nonregulated sectors. We are seeking to promote an equitable sharing of common costs; but we would not think it proper to attempt through cost allocation rules to arrange a subsidy for regulated activities. [Footnote omitted.][11]

41. The bottom line is that each ILEC's nonregulated activities, including in-region long distance services, must not only bear their full direct costs, but also an allocated portion of joint costs and common overhead which would otherwise be borne entirely by regulated services if nonregulated activities were not offered. As a result, customers of regulated services are decidedly better off whenever the ILEC is allowed to provide more nonregulated activities because that means more joint and common costs will be allocated to such activities. It also means that the competitors of the ILEC's nonregulated activities actually enjoy somewhat of an inherent cost advantage due to such allocations.

42. Since the FCC's accounting safeguards were enacted in 1988, there has been considerable debate about whether they are, in fact, operating effectively. In my opinion, they are

[11] Joint Cost Order, ¶ 109.

working extremely well at both preventing and detecting cross-subsidies of nonregulated activities.

43. In the past, there were several well-publicized instances of alleged non-compliance with the accounting safeguards. While I will not attempt to address specific facts concerning compliance, it is fair to say that the amounts involved in virtually all of these cases were clearly insignificant. The materiality of errors in joint cost allocations is properly measured in relation to the costs apportioned to regulated services, not nonregulated activities. Cross-subsidy only occurs when the costs used to develop prices for regulated services improperly include costs of nonregulated activities. In many of the cases which have been cited as examples of significant non-compliance with the FCC's accounting safeguards, had the amounts in question been allocated to nonregulated activities instead of regulated services, the effect on the rates of regulated services would have been negligible. In pointing this out, I by no means imply that compliance with the accounting safeguards is not of utmost importance. It is. Rather, incorrect interpretations and errors in applying any complicated regulatory requirements are to be expected and should be evaluated with consideration to their materiality.

44. My own profession has been criticized for our independent audits of joint cost allocations in the FCC's accounting safeguards program. A 1993 Government Accounting Office report concluded that certain independent audits had not been performed in compliance with FCC guidance in all cases. It recommended that the FCC's audit staff be increased to perform more complete reviews of the independent audits and additional audit work of its own.[12] The FCC did increase its audit activities in response to this report, thus further strengthening the enforcement mechanisms contained within the accounting safeguards.

45. In my opinion, the independent audits have been a highly effective tool. My own experience has been that most of the cases of potential non-compliance with the joint cost rules which have been addressed by the FCC were first identified during independent audits. Many of these involved interpretations of FCC rules and the relevant facts and

[12] United States General Accounting Office, Report to Congressional Requesters, *Telecommunications - FCC's Oversight Efforts to Control Cross-Subsidization*, February 1993.

positions were documented for the FCC staff's consideration and resolution during the course of its review of the independent audits.

CHANGES TO THE ACCOUNTING SAFEGUARDS

46. The accounting safeguards are not static but rather are constantly being fine-tuned and strengthened to reflect the FCC's experience with their application and to address emerging issues. As in all FCC proceedings, interested parties have had the opportunity to provide input on proposed rules changes. The FCC has issued guidance addressing a number of issues including:

- Application of the affiliate transaction rules including the use of prevailing prices and the computation of fully distributed costs.
- Uniformity of cost allocation manuals and procedures and required support for proposed modifications and revisions.
- The scope of independent audits and the format and content of auditor documentation to facilitate FCC staff review.

47. In addition, the FCC significantly strengthened its cost allocation rules, specifically with respect to affiliate transactions, in its Accounting Safeguards Order. As discussed above, the FCC prescribed its asymmetrical affiliate transaction rules previously applicable only to asset transfers to services provided between regulated carriers and their nonregulated affiliates effective July 21, 1997. In addition, the Commission clarified its rules regarding the use of prevailing price in the provisions of products and services between regulated carriers and their nonregulated affiliates. These new accounting safeguards further mitigate the risk of cross-subsidization.

APPLICATION OF ACCOUNTING SAFEGUARDS

48. In its PFR, USTA requests that the FCC require, for accounting purposes only, ILECs providing in-region interstate domestic interexchange services or in-region international

interexchange services to separate and allocate the costs of such services from regulated local exchange operations pursuant to the Part 64 rules as if its in-region interexchange services were nonregulated costs. In other words, the joint cost allocation rules discussed above would apply to appropriately segregate the costs of in-region interLATA long-distance services from regulated local exchange and exchange access services.

49. USTA correctly points out that there is sufficient precedent for the treatment of regulated services as nonregulated for accounting purposes and vice versa. In the Accounting Safeguards Order the FCC states:

> 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.[13]

Similarly, the billing and collection provisions of the Joint Cost Order prescribed specific regulated accounting treatment for billing and collection services, which had previously been detariffed in the interstate jurisdiction. The FCC stated in this instance that:

> We believe that billing and collection activities should continue to be accorded regulated accounting treatment.... In these circumstances, it is appropriate to require subject carriers to continue to classify billing and collection as a regulated activity until such time as it is shown that such accounting treatment misallocates such costs between the jurisdictions.[14]

The Commission further decided to treat preemptively deregulated activities as nonregulated for interstate regulatory accounting and cost allocation purposes. Services that were subsequently reclassified as regulated services in certain state jurisdictions, such as inside wire installation and maintenance, retained a nonregulated classification through the jurisdictional separations process and were reclassified as regulated activities for state ratemaking purposes subsequent to separations.

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[13] Accounting Safeguards Order, ¶75.

[14] Joint Cost Order, ¶81.

50. As demonstrated above, there is clearly precedent to support the unique classification of activities solely for regulatory accounting and cost allocation purposes. The FCC accounting safeguards have efficiently and effectively ensured that the costs related to such activities have been allocated appropriately to prevent cross-subsidization.

51. Thus, the Commission could achieve proper cost allocations and prevent the cross-subsidy of ILEC in-region interLATA long-distance operations without imposing a legal entity structural separation requirement.

52. In the alternative, should the Commission continue to prescribe the Competitive Carrier Fifth Report and Order[15] requirements to ILEC in-region interLATA long-distance operations, the accounting safeguards would afford another alternative to structural separation via the section 32.27 affiliate transaction rules. The Competitive Carrier Fifth Report and Order requirements have operated in conjunction with the accounting safeguards since 1988 to enable nondominant carrier regulation of ILEC long-distance operations without structural separation. Should the Commission retain these requirements and classify in-region long-distance activities as nonregulated for Federal accounting purposes, as suggested by USTA, the existing section 32.27 affiliate transaction rules would continue to apply and nonregulated activities could be conducted within the existing ILEC legal entity.

SUMMARY

53. If USTA's petition to allow the ILECs to provide in-region, interLATA long distance services absent a separate legal affiliate is granted, FCC accounting safeguards already in place are sufficient to ensure that regulated local exchange and exchange access services will not subsidize such services. These accounting safeguards have been in effect for over eight years and will require few, if any, changes to address the needs of the 1996 Act with respect to the ILECs' provision of in-region interLATA long-distance services.

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[15] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, CC Docket No. 79-252, Fifth Report and Order, 98 FCC 2d 1191, (1984) at 1198, [hereinafter Competitive Carrier Fifth Report and Order.]

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

Carl R. Geppert

Carl R. Geppert

Subscribed and sworn to before me this 1st day of August 1997.

Diana L. Atencio

Notary Public

MY COMMISSION EXPIRES
MARCH 6, 1998

APPENDIX A

Corrected Version -- Part 64, Subpart T of Title 47 of the Code of Federal Regulations

PART 64 -- MISCELLANEOUS RULES RELATING TO COMMON CARRIERS

Subpart T -- Requirements For Independent Incumbent Local Exchange Carriers That Provide In-Region, Interstate Domestic Interexchange Services Or In-Region International Interexchange Services

Subpart T -- Requirements For Independent Incumbent Local Exchange Carriers That Provide In-Region, Interstate Domestic Interexchange Services Or In-Region International Interexchange Services

§ 64.1901 Basis and purpose.

(a) *Basis*. These rules are issued pursuant to the Communications Act of 1934, as amended.

(b) *Purpose*. The purpose of these rules is to regulate the provision of in-region, interstate, domestic, interexchange services and in-region international interexchange services by independent incumbent local exchange carriers.

§ 64.1902 Terms and definitions.

Terms used in this part have the following meanings:

~~*Books of Account*. Books of account refer to the financial accounting system a company uses to record, in monetary terms the basic transactions of a company. These books of account reflect the company's assets, liabilities, and equity, and the revenues and expenses from operations. Each company has its own separate books of account.~~

Incumbent Local Exchange Carrier (Incumbent LEC). The term incumbent local exchange carrier means, with respect to an area, the local exchange carrier that:

(1) On February 8, 1996, provided telephone exchange service in such area; and
(2) (i) On February 8, 1996, was deemed to be a member of the exchange carrier association pursuant to § 69.601(b) of this title; or

(ii) Is a person or entity that, on or after February 8, 1996, became a successor or assign of a member described in paragraph (2)(i) of this section.

The Commission may also, by rule, treat a local exchange carrier as an incumbent local exchange carrier pursuant to section 251(h)(2) of the Communications Act of 1934, as amended.

Independent Incumbent Local Exchange Carrier (Independent Incumbent LEC). Independent incumbent local exchange carriers are incumbent local exchange carriers, including GTE, other than the BOCs.

Independent Incumbent Local Exchange Carrier Affiliate (Independent Incumbent LEC Affiliate). An independent incumbent local exchange carrier affiliate is a carrier that is owned (in whole or in part) or controlled by, or under common ownership (in whole or in part) or control with, an independent incumbent local exchange carrier.

In-Region Service. In-region service means telecommunications service originating in an independent incumbent local exchange carrier's local service areas; or 800 service, private line service, or their equivalents that:

(1) Terminate in the independent LEC's local exchange areas; and

(2) Allow the called party to determine the interexchange carrier, even if the service originates outside the independent LEC's local exchange areas.

Local Exchange Carrier. The term local exchange carrier means any person that is engaged in the provision of telephone exchange service or exchange access. Such term does not include a person insofar as such person is engaged in the provision of a commercial mobile service under section 332(c), except to the extent that the Commission finds that such service should be included in the definition of that term.

~~§ 64.1903~~ ~~Obligations of all incumbent independent local exchange carriers~~.

~~(a) Except as provided in paragraph (c) of this section, an incumbent independent LEC providing in-region, interstate, interexchange services or in-region international interexchange services shall provide such services through an affiliate that satisfies the following requirements~~:

~~(1) The affiliate shall maintain separate books of account from its affiliated exchange companies. Nothing in this section requires the affiliate to maintain separate books of account that comply with Part 32 of this title~~;

~~(2) The affiliate shall not jointly own transmission or switching facilities with its affiliated exchange companies. Nothing in this section prohibits an affiliate from sharing personnel or other resources or assets with an affiliated exchange company; and;~~

~~(3) The affiliate shall acquire any services from its affiliated exchange operations for which the affiliated exchange operations are required to file a tariff at tariffed rates, terms, and conditions. Nothing in this section shall prohibit the affiliate~~

~~from acquiring any unbundled network elements or exchange services for the provision of a telecommunications service from affiliated exchange operations, subject to the same terms and conditions as provided in an agreement approved under section 252 of the Communications Act of 1934, as amended.~~

~~(b) The affiliate required in paragraph (a) of this section may be a division of affiliated exchange operations and need not be a separate legal entity. The affiliate may be staffed by personnel of affiliated exchange operations, housed in existing offices of affiliated exchange operations, and use affiliated exchange operations' marketing and other services, subject to paragraph (a)(3) of this section.~~

~~(c) An independent incumbent LEC that is providing in-region, interstate, domestic interexchange services or in-region international interexchange services prior to April 18, 1997, but is not providing such services through an affiliate that satisfies paragraph (a) of this section as of April 18, 1997, shall comply with the requirements of this section no later than April 18, 1998.~~

§ 64.1903 Separation and Allocation of Costs.

(a) For federal accounting purposes only, any independent incumbent local exchange carrier providing in-region, interstate domestic interexchange services or in-region international interexchange services shall 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-region international interexchange services were nonregulated costs.