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FEDERAL COMMUNICATIONS COMMISSION
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1998 Biennial Regulatory Review -- Review of Accounting and Cost Allocation Requirements	)	CC Docket No. 98-81
United States Telephone Association Petition for Rulemaking	)	ASD File No. 98-64
1998 Biennial Regulatory Review -- Review of ARMIS Reporting Requirements	)	CC Docket No. 98-117

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REPLY COMMENTS OF AT&T CORP.

Pursuant to the Commission's Notices of Proposed Rulemaking in CC Docket No. 98-81, FCC 98-108, released June 17, 1998 ("Cost Allocation NPRM"),[1] and in CC Docket No. 98-117, FCC 98-147, released July 17, 1998 ("ARMIS NPRM"), AT&T Corp. ("AT&T") submits these reply comments on the Commission's proposals to revise its accounting, cost allocation and Automated Reporting Management Information System ("ARMIS") requirements for incumbent local exchange carriers ("LECs" or "ILECs").

INTRODUCTION

In the Cost Allocation NPRM, the Commission proposed Class B accounting treatment, including cost allocation manuals ("CAMs") based on Class B level of accounting detail, and biennial CAM attest audits for mid-size LECs. In the ARMIS NPRM, the Commission

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[1] Because of the interrelated nature of the issues in these proceedings, the Commission extended the reply comment date on the Cost Allocation NPRM so that it would coincide with the reply date for the ARMIS NPRM. See Order, CC Docket No. 98-81 and ASD File No. 98-64, DA 98-1545, released August 3, 1998.

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proposed to streamline various ARMIS reports for mid-size LECs by (1) eliminating certain tables from the ARMIS 43-02 USOA Report, and (2) allowing the financial reports to be filed at the Class B level of accounting detail which would further diminish the information available not only in the USOA Report but also the ARMIS 43-03 Joint Cost Report, ARMIS 495A Forecast Report and ARMIS 495B Actual Usage Report, all of which relate to regulated/nonregulated activity reporting. Although the Cost Allocation NPRM and ARMIS NPRM both suggested certain unobjectionable changes that would apply to all ILECs, for the most part, the Commission did not propose significant modifications to the accounting, cost allocation and ARMIS reporting safeguards for the largest carriers, namely, the RBOCs and GTE.

In general, the mid-size LECs welcome the Commission's proposals,[2] but complain that the Commission did not go far enough, for example, by failing to recommend that ARMIS reports be eliminated altogether for them.[3] The RBOCs and GTE gripe that the Commission has failed to discharge its responsibility under Section 11 of the Communications Act, 47 U.S.C. § 161, by not conducting a thorough review of every accounting and reporting obligation for the largest ILECs and by essentially confining its proposed reforms to mid-sized carriers.[4] The large LECs also assert that under the FCC's mandatory price cap regulation with no sharing, they have no ability to cross-subsidize and therefore they too should be entitled, at a minimum, to the same reforms that the Commission has proposed for the mid-size LECs.

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[2] ALLTEL 98-81 Comments at 4; Cincinnati Bell 98-81 Comments at iii-iv.

[3] Cincinnati Bell 98-117 Comments at 5; Sprint 98-117 Comments at 1-2.

[4] USTA 97-81 Comments at 5; Ameritech 98-117 Comments at 2; Bell Atlantic 98-117 Comments at 3; BellSouth 98-117 Comments at 2, 7; GTE 98-117 Comments at 2, 10; SBC 98-117 Comments at 2, 14, 18-19.

Contrary to these assertions, the Commission should <u>not</u> streamline accounting, cost allocation or ARMIS requirements for the mid-size LECs, and certainly not for the RBOCs and GTE. Class A accounting treatment, detailed CAM filings and audits, and ARMIS reports are all part of the Commission's regulatory tools to ensure that prices are just, reasonable and nondiscriminatory. Robust competition in the LECs' local markets that could conceivably obviate the need for these regulatory tools does not yet exist. Thus, there is no basis for disturbing the Commission's findings that these requirements remain useful and necessary to protect consumer interests.

I. THE COMMISSION HAS FAILED TO IDENTIFY ANY VALID PREDICATE FOR STREAMLINING ACCOUNTING, COST ALLOCATION OR ARMIS REPORTING REQUIREMENTS.

Section 11 of the Communications Act requires the FCC to undertake a biennial review of all its regulations and "determine whether any such regulation is no longer necessary in the public interest as the result of meaningful economic competition between providers of such service." It could not be clearer that under this standard the streamlining of accounting, cost allocation and ARMIS requirements is entirely <u>inappropriate</u> for both mid-size and large ILECs.[5]

For one, the Commission does not even purport to articulate any competitive inroads into the local exchange and exchange access markets that could conceivably form a legitimate basis for such reform. And, there are none. As GSA points out, the ILECs still retain the overwhelming share of local service revenues, on average in the range of 99 percent.[6] And, as

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5 For this reason, there is likewise nothing improper about not entertaining all the additional streamlining proposals suggested by USTA and BellSouth in their 98-81 and 98-117 filings or the Arthur Andersen paper submitted with Ameritech's 98-81 Comments.

6 GSA 98-117 Comments at 4, citing Trends in Telephone Service, Feb. 1998, Table 8.1.

AT&T and others have shown in prior proceedings, meaningful competition sufficient to constrain the ILECs' access rates has not emerged and is not likely to develop in the forseeable future.[7]

Instead of adhering to Section 11's statutory standard of predicating regulatory relief based on meaningful competition, the primary basis for the Commission's ARMIS streamlining proposal is the Commission's observation that "it appears that the carriers' costs of implementing [the ARMIS reporting system] are largely fixed with respect to the number of access lines served," and "[t]his implies that, on a per-access-line basis, the cost of complying with the full ARMIS reporting requirements is substantially higher for mid-size incumbent LECs" than for larger ILECs (ARMIS NPRM, para. 6). As AT&T showed, whether or not the Commission's conclusion is correct, the regulatory benefits of maintaining ARMIS reports in their current form outweigh the costs imposed on mid-size LECs of preparing these reports.[8]

Similarly, in the Cost Allocation NPRM (para. 5), instead of any finding of meaningful competition as required by Section 11, the Commission tentatively concludes that it could maintain the necessary degree of oversight for mid-size LECs while imposing less burdensome accounting requirements because these firms typically conduct a lower volume of transactions involving competitive products and services than the largest LECs. However, according to the evidence presented in the comments, the mid-size carriers' nonregulated activities are comparable to, and in some instances, greater than those of larger carriers as a percentage of

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7 AT&T Comments, filed January 30, 1998, in Request for Amendment of the Commission's Rules Regarding Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers, RM No. 9210, at 4-16; see also Stonewalling Local Competition: The Baby Bell Strategy to Subvert the Telecommunications Act of 1996, at 16-20 ("CFA Study") in that docket.

8 AT&T 98-117 Comments at 4, 6-7.

operating expenses.[9] The conclusion to be drawn from this is not, however, as the RBOCs and GTE suggest, that they too should be entitled to the same relief, but rather that the Commission's putative basis for relaxing accounting and cost allocation safeguards is without foundation as to even the mid-size LECs. Moreover, assuming that the RBOCs' and GTE's percentage of nonregulated activities are at a comparable level on a proportional basis to those of mid-size LECs, the absolute dollar amounts are far higher and thus the ratepayer impact of any cost-shifting is that much greater for the largest carriers.[10]

II. STREAMLINING ACCOUNTING, COST ALLOCATION AND ARMIS REQUIREMENTS WOULD UNDERMINE THE COMMISSION'S ABILITY TO SAFEGUARD CONSUMERS.

As MCI and AT&T demonstrate, allowing Class B accounting (which the Commission has proposed for the mid-size LECs and which the RBOCs and GTE also urge should be adopted for themselves[11]) would mean that the Commission (and state regulators) will lose a significant amount of cost and revenue detail that has proven invaluable in: (1) tariff investigations; (2) identification of cost-shifting and cost misallocations; (3) improving cost

9 SBC 98-81 Comments at 2; Ameritech 98-81 Reply Comments at 2; GTE 98-81 Comments at iii; ITTA 98-81 Comments at 3; Ameritech 98-117 Comments at 7; GTE 98-117 Comments at 8; SBC 98-117 Comments at 13.

10 According to the USTA roll-up of RBOC and GTE results, the large LECs account for some $5.6 billion in nonregulated expenses, as compared to $0.9 billion for other LECs required to file an ARMIS 43-03 Joint Cost Report. USTA 98-81 Comments at 7-8. Even the computation of the relative relationship of nonregulated expenses to total operating expenses may be skewed, however, by the fact that the RBOCs and GTE conduct more of their nonregulated activities through separate affiliates, thereby diminishing the amount of nonregulated expenses that would appear on their ARMIS 43-03 Reports.

11 Indeed, several parties suggest that the Commission should eliminate Part 32 accounts altogether and instead rely on their GAAP books as the sole source of data for regulatory oversight. Bell Atlantic 98-81 Comments at 7-9; U S WEST 98-81 Comments at 10; USTA 98-81 Comments at ii-iii.

allocations; (4) estimating the ILECs' costs of providing wholesale services; (5) conducting cost proxy models for universal service support for non-rural LECs;[12] and (6) tracking competitive changes in local markets.[13] For example, as the Pennsylvania Commission shows, Class A accounting is a principal source of data used by regulators to determine the validity of LEC assertions, and revision of Part 32 accounting standards could undermine the government's ability to obtain detailed information, for example, about the financial treatment of facilities, services and technologies related to advanced services.[14]

Decreasing the frequency of CAM audits and permitting a less stringent attest audit (as compared to the current annual positive audit) would also undermine the Commission's ability to detect improper cost allocations. In its CC Docket 86-111 joint cost proceedings, the Commission determined that the requirement for an annual positive opinion audit is "an indispensable factor in [the Commission's] ability to enforce the rules [the Commission] established."[15] This is nowhere more critical than today as ILECs enter new nonregulated markets.[16]

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12 In addition to the RBOCs and GTE, many mid-size LECs are non-rural carriers.

13 MCI 98-81 Comments at 3-5 (citations omitted); AT&T 98-117 Comments at 7.

14 Pennsylvania PUC Motion to File Ex Parte Comment and Comment, AAD File Nos. 98-22 and 98-23, and CC Docket No. 98-81 and ASD File No. 98-64, August 3, 1998, at 3-6.

15 Separation of Costs of Nonregulated Telephone Service from Costs of Regulated Activities, CC Docket No. 86-111, Order on Reconsideration, 3 FCC Rcd 6283, 6304, para. 184 (1987); Report and Order, 2 FCC Rcd 1298, 1330, para. 254 (1987).

16 Many of the mid-size companies, including Sprint (the third largest long distance carrier in the nation), CBT, Rochester, Aliant and SNET, are active players in the in-region long distance market and clearly have an incentive to cross-subsidize their long distance operations. And, the Commission is faced with a continuing stream of Section 271 applications as the RBOCs seek to enter the in-region long distance market.

As AT&T showed in both its comments on ITTA's petition[17] and its 98-117 comments, the Commission's proposals to give mid-size LECs significant cost accounting and ARMIS relief are inconsistent with the FCC's own finding in implementing the $112 million indexed threshold for Class A treatment that "for carriers with annual revenues in excess of this threshold . . , the benefits to ratepayers outweigh the cost to those carriers of requiring compliance" [with CAM cost allocation and ARMIS] requirements.[18] The ruling was issued only last year and there are no relevant changed circumstances that would warrant the Commission creating an exponentially higher $7 billion threshold, thereby exempting all mid-size LECs from detailed cost accounting and ARMIS requirements, or acting favorably on the RBOCs' and GTE's requests for like treatment.

Most fundamentally, the Commission specifically concluded that ARMIS reports are "necessary to provide us with the financial and operating data we need to administer our accounting, cost allocation, jurisdictional separations, and access charge rules, and to preserve our ability to monitor industry developments and quantify the effects of alternative regulatory proposals."[19] The Commission also noted the need to detect improper cross-subsidization of nonregulated services, stating that "ARMIS reports enable us to monitor whether all costs have

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17 As AT&T showed in its Comments, filed May 4, 1998 in AAD 98-43, DA 98-480, on the Petition for Forbearance filed by the Independent Telephone & Telecommunications Alliance on behalf of mid-size LECs, the Commission should not forbear from Class A Part 32 accounting requirements, CAM filings and audits, and ARMIS reports for these carriers. AT&T incorporates by reference those Comments herein. See also AT&T 98-117 Comments at 4-6.

18 Implementation of the Telecommunications Act of 1996: Reform of Filing Requirements and Carrier Classifications, CC Docket No. 96-193, Order and Notice of Proposed Rulemaking, 11 FCC Rcd. 11716, paras. 7-12 (1996); Report and Order, 12 FCC Rcd. 8088, para. 70 (1997) ("Reform of Filing Requirements Order").

19 Reform of Filing Requirements Order, 11 FCC Rcd. 11716, para. 32.

been properly allocated to regulated and nonregulated products and services."[20] Additionally, "ARMIS reports have been a valuable source of cost information to the Commission in its evaluation of tariffs filed under rate-of-return regulation. Cost information from these reports has also played an important role in tariff investigations, certain rulemakings concerning cost issues, and in the evaluation of exogenous cost adjustments under the price cap rules (for example, in determining the cost effects of property transfers)."[21]

In short, whether or not the compliance costs of the mid-size LECs are likely to be relatively higher than those of larger carriers, the Commission's accounting, cost allocation and ARMIS requirements are part of the Commission's regulatory tools to ensure that prices are just, reasonable and nondiscriminatory in order to protect consumers. Robust competition in the LECs' local markets that could conceivably obviate the need for these regulatory tools does not yet exist. Thus, there is no basis for disturbing the Commission's findings that ARMIS reports at the Class A level of account detail, CAMs and audits as currently defined remain useful and necessary tools to safeguard consumer interests.

Moreover, with respect to the RBOCs and GTE, it could not be clearer that retaining the existing accounting, cost allocation, CAM and ARMIS safeguards is crucial. Not only do these carriers command 90 percent of the nation's interstate access revenues, but they are entrenched monopolists in their respective local exchange and exchange access markets. As GSA observes:

> "As a large user of ILEC telecommunications services, GSA believes stringent accounting safeguards must be maintained for the large ILECs as long as they

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20 Id., 12 FCC Rcd. 8088, para. 53.

21 Id., 12 FCC Rcd. 8088, n.135.

> retain significant market power in the local exchange and exchange access markets."
>
> GSA further "found the information in the ARMIS reports to be invaluable in participating in proceedings before this Commission and state regulatory bodies."[22]

The RBOCs' and GTE's primary basis for contending that Class A accounting, cost allocation safeguards and detailed ARMIS reports are no longer critical is the fact that they are under price cap regulation. The fact that the RBOCs and GTE are subject to mandatory price cap regulation with no sharing for their interstate access services, does <u>not</u> mean that they cannot cross-subsidize their nonregulated offerings through their regulated access services. Price caps do not themselves eliminate LEC incentives to manipulate the assignment of costs between regulated and nonregulated operations.[23] As MCI correctly demonstrates, accounting and cost allocation safeguards are needed under price caps for: (1) the lower formula adjustment; (2) above cap filings; (3) exogenous cost adjustments; (4) computation of subscriber line charges; and (5) earnings monitoring to prevent the ILECs from using their market power to earn exorbitant returns.[24] And, as AT&T showed, booked costs also have continuing relevance in the periodic adjustment of the productivity factor ("X") in the price cap formula, which has a critical impact on the overall level of these carriers' interstate access rates.[25]

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22 GSA 98-117 Comments at 4, 2.

23 As Bell Atlantic concedes, even under price caps, booked costs remain relevant to computation of the subscriber line charge and exogenous adjustments. Bell Atlantic 98-117 Comments at 3.

24 MCI 98-117 Comments at 5; <u>see also</u> AT&T Reply Comments, filed September 10, 1996, in <u>Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996</u>, CC Docket No. 96-150, at 4 ("AT&T 96-150 Reply Comments").

25 AT&T 96-150 Reply Comments at 3 (Productivity is derived from the price cap LECs' reported costs).

Moreover, a recent preliminary audit by the FCC notes that the RBOCs cannot locate an estimated $5 billion worth of communications equipment that they claim on their regulated books.[26] This, along with an earlier audit report that "a staggering 36.3 percent of the physical assets of GTE Corporation are either missing or unverifiable," recently prompted Congressman Bliley to write to FCC Chairman Kennard, stating:

> "If, as the report suggests, these carriers did inflate their recorded investments, then consumers may have been overcharged millions of dollars in their monthly telephone bills."
>
> "But unfortunately the consequences may be greater. These carriers' books of accounts are being used to resolve a number of important issues at both the federal and state levels -- including ongoing federal and state efforts to promote local competition. If these books of accounts have been inflated with investments that cannot be located or do not exist, then competitive carriers seeking interconnection to the local exchange are bearing unnecessary cost, thereby harming competition in the local exchange market."[27]

This is hardly the time to relax accounting, cost allocation or ARMIS safeguards for these carriers.

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26 M. Mills, "FCC Audit Cites Bells' Lost Items; Finding Could Spur Push for Rate Cuts," The Washington Post, August 13, 1998, 1998 WL 16549626, ALL NEWS.

27 Letter, dated August 19, 1998, from the Honorable Thomas Bliley, Chairman, U.S. House of Representatives, Committee on Commerce, to FCC Chairman William E. Kennard, at 1-2.

CONCLUSION

For the reasons stated above, the Commission should not adopt its own (or the LECs') proposals to streamline accounting, cost allocation and ARMIS rules for mid-size incumbent LECs or for the RBOCs and GTE.

Respectfully submitted,

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September 4, 1998

CERTIFICATE OF SERVICE

I, Rena Martens, do hereby certify that on this 4th day of September, 1998, a copy of the foregoing "Reply Comments of AT&T Corp." was served by U.S. first class mail, postage prepaid, to the parties listed below.

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