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June 4, 1999

Ms Magalie Roman Salas
Office of the Secretary
Federal Communications Commission
445 12 Street SW, Counter TWA 325
Washington, D.C. 20554

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Re: CC Docket No. 99-117, Comments in Response to April 6, 1999 Notice of Inquiry: ASD File No. 99-22, Audit of Continuing Property Records of the NYNEX Telephone Operating Companies Also Known As Bell Atlantic North.

Dear Ms. Salas:

The attached comments of New York State Attorney General Eliot Spitzer are hereby submitted pursuant to the Commission's April 6, 1999 Notice of Inquiry. Pursuant to 47 C.F.R. §§ 1.415, 1.419 and 1.430 and 63 Fed. Reg. 24,121 (1998), this filing is being made electronically to be considered by the Commission and its staff in CC Docket No. 99-117 and ASD File No. 99-22.

Sincerely,

Keith H. Gordon
Assistant Attorney General

cc: Maureen Helmer, Chairman, New York State Public Service Commission
Stephen Ward, Maine Public Advocate
George Dean, Massachusetts Attorney General, Regulated Industries Division
Michael W. Holmes, New Hampshire Consumer Advocate
Douglas Elfner, New York State Consumer Protection Board
James Volz, Vermont Division of Public Advocacy
Christine S. Jabour, Rhode Island Attorney General - Consumer Protection Unit
Hugh Boyle, Director, Accounting Safeguards Division

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC. 20554

In the Matters of:	)	
Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit	))	
Bell Atlantic (North)Telephone Operating Companies' Continuing Property Records Audit	))	CC Docket No. 99-117
Bell Atlantic (South) Telephone Operating Companies' Continuing Property Records Audit	))	ASD File No. 99-22
Bell South Telecommunications' Continuing Property Records Audit	))	
Pacific Bell and Nevada Bell Telephone Companies' Continuing Property Records Audit	))	
Southwestern Bell Telephone Company's Continuing Property Records Audit	))	
US West Telephone Companies' Continuing Property Records Audit	))	

Comments of Eliot Spitzer
Attorney General of the State of New York

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June 4, 1999

Background

By Order dated February 24, 1999, the Federal Communications Commission ("FCC" or "Commission") released the results of its audit of the continuing property records of the Regional Bell Operating Companies ("RBOCs").[1] These audits were performed by the Common Carrier Bureau's Accounting Safeguards Division ("ASD"). Under the Commission-prescribed Uniform System of Accounts, each operating telephone company subsidiary of the RBOCs is required to maintain continuing property records describing all capital equipment, identifying its location, referencing its installation work order(s), dating its installation and showing its cost. The Commission's rules provide that such records shall be kept so that they can be checked for accuracy.[2]

Such continuing property records, which document the cost, age, location, and use of each telephone company's capital investment, provide the basis for the FCC to make numerous determinations, including jurisdictional separations, cost allocations between regulated and unregulated affiliates and operations, access charge allocations, allowed earnings, and rates. In addition, state utility regulatory agencies rely on the FCC's Uniform System Of Accounts ("USOA") to review the RBOCs' intrastate plant investments. In particular, the New York Public Service Commission's determinations of jurisdictional separations, intrastate price cap levels, and other significant findings rely on the capital investment stated in NYNEX/Bell Atlantic North's continuing property records.

The FCC audits examined each RBOC's records to determine compliance with the requirements for maintaining continuing property records, and to verify, by means of statistical

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[1] Report No. CC 99-3, Orders FCC 99-29, 99-30, 99-31, 99-32, 99-33, 99-34, and 99-35.

[2] 47 C.F.R. § 32.2000(f)(5).

sampling, the accuracy of the current capital equipment figures on the companies' books. In each RBOC review, the auditors identified substantial shortcomings in record keeping compliance, and were unable to locate significant amounts of capital equipment claimed on the RBOCs' continuing property records. The auditors concluded that the RBOCs had collectively overstated their capital investment by more than $5 billion.[3]

On April 6, 1999, the Commission adopted a Notice of Inquiry ("NOI")[4] inviting interested parties to comment on ten issues the RBOCs raised in rebuttals to the audits.[5] The Attorney General's comments address these issues and recommend a course of action in the discussion below. These comments focus on the NYNEX/Bell Atlantic North audit, which was issued December 22, 1998 and reviewed the condition of the continuing property records as of March 31, 1997.[6]

Summary of Audit Findings

In 1994, the Common Carrier Bureau's Accounting Safeguards Division began an informal audit of the continuing property records of NYNEX's central office equipment.[7] Based on the discrepancies identified by this non-statistical sample, a more comprehensive audit was conducted of the company's "hard-wired equipment" in place as of March 1997. The 1997 audit selected a

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[3] FCC News Release dated February 25, 1999, Report No. 99-3. See also, Statement of Commissioner Gloria Tristani released on March 12, 1999 with the Commission's February 24, 1999 Order that made the audit reports public.

[4] CC Docket No. 99-117, ASD File No. 99-22, *Notice of Inquiry*, adopted April 6, 1999.

[5] E.g., *Response To Audit Staff Draft Report of Findings Related to Audit of Continuing Property Records of Bell Atlantic*, dated January 11, 1999.

[6] *Audit of the Continuing Property Records of the NYNEX Telephone Operating Companies Also known as Bell Atlantic North as of March 31, 1997*, ASD File No. 99-22, issued December 22, 1998. The audit examined into the investment in central office equipment capital items in New York, Maine, Massachusetts, Vermont, Rhode Island, and New Hampshire.

[7] Ibid, p. 5..

random sample of items recorded on NYNEX/Bell Atlantic North's property books and then the existence of these selected pieces of equipment was checked in the field.[8] The auditors found substantial deficiencies in NYNEX/Bell Atlantic North's records: property worth $381.5 million that could not be located in the central offices where NYNEX/Bell Atlantic North's records claimed it to be.[9] The auditors identified similar discrepancies totaling $795.6 million in two other categories of NYNEX/Bell Atlantic North's continuing property records.[10]

The auditors concluded that the errors in NYNEX/Bell Atlantic North's continuing property records were so numerous as to demonstrate that the company's books did not comply with the Commission's rules. The auditors further concluded that the problems uncovered were so longstanding that it was not likely that NYNEX/Bell Atlantic North could correct them without outside assistance.[11] The auditors recommended that NYNEX/Bell Atlantic North be required to retain an independent accounting firm to perform a comprehensive inventory and audit of the company's entire continuing property records, practices, procedures and controls.[12] The auditors recommended further that the FCC order NYNEX/Bell Atlantic North to write off $758.2 million from its central office equipment capital account, reverse capital equipment retirement entries made in 1995 and 1996, and write off an additional $291 million from the company's books.[13] In addition to these recommended accounting corrections, the auditors identified $418.9 million of

[8] Ibid., p. 11.

[9] Ibid., p. 17, ¶ 39 and Appendix A, p. 14.

[10] Id.

[11] Ibid., p. 17, ¶¶ 36-37. After the FCC's 1994 informal audit of NYNEX/Bell Atlantic North's continuing property records identified similar deficiencies, the company performed a review and notified the Commission that it had remedied its property record practices and controls.

[12] Ibid., p. 17, ¶ 40.

[13] Ibid., p. 17, ¶ 39.

"unsubstantiated" capital costs that it will consider after receiving NYNEX/Bell Atlantic North's promised supplemental explanatory submission.[14]

Interest of the New York Attorney General

The New York State Attorney General is an advocate on behalf of New York State's residential and small business utility ratepayers, before both the FCC and the New York State Public Service Commission ("NYPSC"). The interest of New York consumers in the FCC's audit of NYNEX/Bell Atlantic North's continuing property records is manifest. Approximately half of NYNEX/Bell Atlantic North's reported costs represent capital investment recorded in the continuing property records. The FCC and the NYSPSC use these cost figures to set NYNEX/Bell Atlantic North's rates. The audit shows that NYNEX/Bell Atlantic North's costs are inflated. New York State telephone customers, both commercial and residential, are adversely affected if the various charges which comprise their rates are inflated because of overstated capital investment figures.

In rough terms, as much as $631 million of NYNEX/Bell Atlantic North's New York intrastate rate base could be affected by a potential $1.18 billion write-off of NYNEX/Bell Atlantic North's capital investment accounts recommended by the auditors. This estimate is based upon the fact that New York Telephone Company represents approximately two-thirds of NYNEX/Bell Atlantic North's operations and about 80% of this is contained in the intrastate jurisdiction. Thus, the auditors' findings, if adopted by the FCC, could lead to significant adjustments in the intrastate and interstate rates paid by New York businesses and residents.

Because the audit appears to have been carried out with thoroughness and rigor and because its recommendations and conclusions have a very significant potential impact on New York

[14] Ibid., p. 14, ¶ 31 and p. 18, ¶ 41.

residential and business phone customers, we urge the FCC to order that NYNEX/Bell Atlantic North show cause why the conclusions reached and the recommendations made by the ASD auditors should not be adopted. The FCC has effectively employed such a procedure in the past in similar circumstances.[15]

Given the magnitude of the auditors' findings and the many major federal and state regulatory determinations potentially affected, it is vital that the FCC complete the task begun by the Common Carrier Bureau's ASD expeditiously. Otherwise, state commissions may have to duplicate the ASD auditors' work, with concomitant delay.

The New York Attorney General's office also recommends that the FCC direct the ASD to perform similar audits of the RBOCs' Plug-In Cards and Outside Plant equipment property records to determine if further adjustments to the company's capital accounts are warranted, or that the Commission select one or more independent auditing firms to do so, with the expense borne by NYNEX/Bell Atlantic North.[16]

Issues Raised By Notice Of Inquiry

Statistical Sampling

The ASD's statistical procedures were reasonable for the circumstances of these audits.[17] The sheer size of the RBOCs' property investment records and the diversity and dispersal of the

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[15] See, *e.g.*, FCC 90-57, *In the matter of New York Telephone Company and New England Telephone And Telegraph Company--Apparent Violations of the Commission's Rules and Policies Governing Transactions with Affiliates* (the FCC ordered NYNEX to show cause why it should not be required to adjust its books to remove unreasonable costs incurred in violation of the Commission's affiliate transactions rules, based upon a CCB audit, which, after commencing an evidentiary proceeding, was resolved by a consent decree adopted October 3, 1990).

[16] The CCB-ASD Audit Report states that Plug-In Equipment comprises 42% of the RBOCs' investment in central office equipment, but was not reviewed because the portability of such items requires a different approach than what was used to audit the hard-wired equipment. December 22, 1998 Audit Report, supra, p. 7.

[17] Ibid., p. 11, ¶¶ 22-23 and Appendix B.

equipment to be audited necessitate that any audit be based on random samples. For example, NYNEX/Bell Atlantic North has approximately 300 central offices in New York State alone. Any attempt to examine of every piece of central office equipment listed on the NYNEX/Bell Atlantic North's continuing property records, which contain 465,600 separate items,[18] would not only exhaust the ASD's resources, but could unreasonably disrupt the company's operations. Thus, use of a sampling methodology is in the best interest of NYNEX/Bell Atlantic North, the Commission, consumers and taxpayers.

The ASD auditors selected 1224 hard-wired equipment items reported in NYNEX/Bell Atlantic North's continuing property records to be in use at 34 central offices (36 discreet pieces of equipment at each central office). The ASD's sampling methodology took care to include multiple locations from each state within the NYNEX/Bell Atlantic North region. Using the continuing property records and other supporting documentation provided by NYNEX/Bell Atlantic North, the auditors visited each location and attempted to identify the randomly selected items reported to be in use at each central office. Once the auditors determined the proportion of equipment items that they could not locate, the associated cost of such "not found" equipment was scaled up proportionately to estimate the discrepancy for the entire continuing property records.

Although NYNEX/Bell Atlantic North criticizes the ASD's sampling methodology and statistical analyses at some length,[19] the company's arguments are unconvincing. The FCC's regulations clearly require that each telephone company maintain its continuing property records in a complete, accurate, and up to date fashion so as to facilitate just the kind of audit under review

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[18] ASD December 22, 1998 audit of NYNEX/Bell Atlantic North's continuing property records, supra, at p. 13, ¶ 27.

[19] See, January 11, 1999 *Response To Audit Staff Draft Report of Findings Related to Audit of Continuing Property Records of Bell Atlantic.*

here. In addition, the ASD's 1994 informal audit of NYNEX/Bell Atlantic North's (then NYNEX) continuing property records identified deficiencies and shortcomings similar to those found in the 1997 audit. Therefore, there was ample warning and opportunity for NYNEX/Bell Atlantic North to bring its continuing property records into compliance with the FCC's rules.

NYNEX/Bell Atlantic North's attempt to supplement its continuing property records after the ASD's 1997 audit is inadequate, at best. The company had ample opportunity to show the auditors while they were inspecting the central offices during 1997-1998 that the items "not found" did in fact exist, but failed to even attempt to do so until January 1999. The Commission's regulations require that all capital investment be thoroughly documented in the continuing property records so that they can be verified by the FCC's auditors, and do not permit RBOCs to create records after the fact.

Furthermore, NYNEX/Bell Atlantic North's post-audit attempt to rehabilitate its deficient continuing property records by trying to locate items "not found" during the audit fails to answer two other major categories of improper capital equipment accounts. The inclusion of "undetailed investment" and "unallocated other costs" on NYNEX/Bell Atlantic North's property records is not authorized by the FCC's Rules. Such unspecified cost items comprised 10% of the total number of entries in NYNEX/Bell Atlantic North's property records. By their very nature, these items are not verifiable through audit as specifically required by the Commission's rules governing property records. Even when given the opportunity to identify such items at three central offices, NYNEX/Bell Atlantic North was unable to document a single item. Nor could the company provide cost support for any of these unspecified items claimed at 34 locations.[20]

The sheer size of the problems identified through the ASD audit, amounting to more than

[20] FCC Audit Report, supra, p. 13.

one billion dollars in undocumented capital investment included in NYNEX/Bell Atlantic North's continuing property records, is clearly well beyond the point that possible statistical error margins could explain all of the deficiencies. The very enormity of the deficiencies underscore that the remedial steps proposed by the auditors are both necessary and appropriate to enforce FCC regulations.

Accounting Adjustments And Corrections

The auditors' recommended corrections and adjustments discussed above were reasonable under the circumstances. Accurate and reliable records of each RBOC's capital investment continues to be essential to properly regulate their provision of bottleneck services to competitors and consumers. Just as the RBOCs expect to recover the cost of their investment in capital equipment through the rates charged for their services, ratepayers expect that these cost figures will not be inflated or obsolete. Federal and state regulators have an obligation to prevent such inflation and inaccuracies by performing audits as appropriate and requiring remedial action to correct significant inaccuracies.

Telephone companies' rates may only be computed based on costs for equipment shown to be used and useful. As these capital investment accounts comprise the single largest element in computing RBOC rates, it is imperative that significant discrepancies such as those documented in the ASD audit be corrected. We support the auditors' recommendation that NYNEX/Bell Atlantic North be ordered to write off $758.2 million from its central office equipment account, reverse retirement entries made in 1995 and 1996 and write off an additional $291 million.[21]

Role For Independent Accounting Firms

The Attorney General agrees with the ASD auditors' recommendation that the FCC select an

[21] Ibid., p. 17, ¶ 39.

independent accounting firm, paid for by NYNEX/Bell Atlantic North, to perform a comprehensive inventory of the company's continuing property records. Such an audit should be supervised by the FCC Staff, which should also design the work plan to be performed. The New York State Public Service Commission employed this approach in its NYNEX affiliate transactions audit, which resulted in substantial remedial relief.[22]

Based on our experience in examining NYNEX's purchasing practices regarding these types of capital equipment,[23] we believe there is reason to examine the Plug-In-Cards and Outside Plant accounts with the same rigor as the ASD applied to the central office equipment.

We also agree that the independent firm should review NYNEX/Bell Atlantic North's property records processes and controls. Such an examination is needed to devise the reforms necessary to bring the company into compliance with the FCC's rules. The fact that NYNEX/Bell Atlantic North claimed it had reformed its property records practices after the FCC's informal 1994 examination, but failed to effect adequate changes as shown by the 1997 formal ASD review, shows that outside intervention is necessary and appropriate.

Ratepayer Impact

What is clear from the ASD audit of NYNEX/Bell Atlantic North's continuing property records is that $1.18 billion in excess investment is a major accounting discrepancy that demands to be corrected. In addition to the contemplated changes at the federal level, each state has relied on the RBOCs' property records to compute rate, price caps, exogenous costs, depreciation,

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[22] See, Case 90-C-0912, *Proceeding on Motion of the Commission to Investigate Transactions Among New York Telephone and its Affiliates,* Opinion 97-9 - Opinion and Order Approving Settlement With Modifications, effective June 5, 1997 (resulting in $83 million of rebates paid to New York consumers).

[23] See, *e.g.*, NYPSC Case 90-C-0912, *Proceeding on Motion of the Commission to Investigate Transactions Among New York Telephone Company and its Affiliates*.

separations, etc. The FCC has an obligation to settle the controversy over the ASD audits of the RBOCs' property records, so that state commissions can examine the appropriate remedial steps required to adjust intrastate rates. Therefore, it is doubly important that the Commission finalize its determination of the issues set out in the NOI expeditiously. Once the amount of write-down is determined, the specific rate impacts can be measured and adjustments made accordingly.

Conclusion

The New York Attorney General applauds the ASD on its efforts to date and urges the Commission to promptly implement the ASD auditors's recommendations so that rates can be adjusted to reflect reality and any rate adjustments can be passed on to ratepayers, at both the state and federal levels.

Respectfully submitted,
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by

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