

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

DOCKET FILE COPY ORIGINAL

In the Matters of)
)
Ameritech Corporation Telephone Operating)
Companies' Continuing Property Records)
Audit)
)
Bell Atlantic (North) Telephone Companies)
Continuing Property Records Audit)
)
Bell Atlantic (South) Telephone Companies)
Continuing Property Records Audit)
)
BellSouth Telecommunications' Continuing)
Property Records Audit)
)
Pacific Bell and Nevada Bell Continuing)
Property Records Audit)
)
Southwestern Bell Telephone Company's)
Continuing Property Records Audit)
)
US WEST Telephone Companies' Continuing)
Property Records Audit)

RECEIVED

SEP 23 1999

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

CC Docket No. 99-117

ADS File No. 99-22

COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY,
PACIFIC BELL AND NEVADA BELL

SOUTHWESTERN BELL TELEPHONE COMPANY
PACIFIC BELL
NEVADA BELL

ALFRED G. RICHTER, JR.
ROGER K. TOPPINS
JONATHAN W. ROYSTON

One Bell Plaza, Room 3005
Dallas, Texas 75202
214-464-5534

Their Attorneys

No. of Copies rec'd
List ABCDE

0+1

September 23, 1999

TABLE OF CONTENTS

Summary.....	i
Introduction.....	1
I. The Audit Results Are Unsound and Unreliable Due to Fundamental Flaws in the Auditors' Sampling and Audit Procedures (Issue 1).....	5
A. Significant Deficiencies Plague the Audit Results, Especially the Dollar Estimates.....	5
B. The Poorly Explained Bayesian Method Cannot Remedy the Fundamental Flaws in the Sample Design and Audit Procedures.....	13
II. The SBC LECs Furnished Sufficient Evidence of the Existence of "Not Found" Items, Which the Auditors Rejected Without Any Explanation (Issue 2).....	16
III. Serious Deficiencies in These Audits Prevent Them from Serving as a Basis to Require Corrective Action (Issue 3).	27
IV. The Auditors' Recommended Write-Off Is Unjustified, Contrary to the Rules and Otherwise Improper (Issue 4).....	33
V. Undetailed Investment Has Been Allowed by the FCC for 30 Years (Issue 5).....	39
VI. Complete Physical Inventories Are Not Justified by the Audits or on a Cost/Benefit Basis (Issue 6).	42
VII. Any Independent Review of Internal Controls Should Include a Review of Methods of Streamlining and Updating the FCC's Asset Tracking Requirements (Issue 7).....	45
VIII. Under Price Cap Regulation, CPR Audits Should Have No Adverse Impact on Ratepayers (Issue 8).	50
A. Account Balances Are Not Used in Setting Rates Under Price Cap Regulation.	50
B. Net Plant Balances Are Not Affected by Normal Retirements.	57

IX.	Embedded Account Balances Are Largely, if Not Completely, Irrelevant to the Determination of Hypothetical Forward-Looking Economic Costs for Universal Service Support and UNE Prices (Issue 9).....	62
X.	Significant Retirements May Increase the RBOCs' Depreciation Reserve Deficiencies (Issue 9(b)(2)).....	64
XI.	The FCC Should Consider this Audit in a Broader Context than the Auditors (Issue 10).....	66
	Conclusion	73
	Exhibit A.....Ernst & Young LLP Review of the Pacific Bell and Nevada Bell CPR Statistical Audit Plan	
	Exhibit B.....Ernst & Young LLP Letter Regarding Rescoring Standards	
	Exhibit C.....Statewide Asset Verification and Retirement	
	Exhibit D.....Declaration of Marla Martin	

Summary*

By seeking public comment on fundamental questions concerning the audit reports, the FCC acknowledges that it is not even sure whether these audit reports are right, and if so, what ratemaking and other impacts, if any, the auditors' conclusions could have under price cap regulation. These sort of matters of general applicability should be decided before beginning such a costly and burdensome activity as these audits rather than at the end of the process.

In their responses, the RBOCs raised many of the same concerns with these audits that are the subject of the issues in the NOI. There were serious problems with the way the auditors conducted these audits, including fundamental flaws in the auditors' sampling and audit procedures. Ernst & Young LLP ("EY") found the following four significant deficiencies:

(1) **Lack of Two-Way Audit.** First, if the auditors wanted to accurately quantify the missing equipment, they should have conducted a two-way audit, instead of only checking to see whether an item in the CPR could be found in the central office. In effect, they only looked at "half of the equation."

(2) **Sample Not Designed To Estimate Dollar Values Accurately.** Second, the auditors designed the audit to measure the proportion of items not found, instead of the dollar value of missing items. The auditors' sample design causes the range of dollar estimates to be highly questionable and subject to significant uncertainty as evidenced by the huge size of the dollar confidence intervals.

(3) **Wide Margins of Error.** Third, the margins of error are very imprecise, and when they are corrected, using the SBC LECs' data, the margins of error are so wide that the results provide little or no useful information concerning the dollar value of property not found, especially when one considers that, as a statistical matter, no single value within the range is any more likely to be correct than any other.

(4) **Biased Estimates.** Fourth, there were many sources of bias that cause further

* The abbreviations in this Summary are defined in the body of these Comments.

inaccuracy in the audit results. Sources of this bias include substitution of items for undesirable ones and weakness in the audit controls.

As a result of sampling deficiencies, the auditors are unable to produce accurate estimates of the value of items alleged to be “not found.” For example, the range of values in the estimate for Pacific is \$433 million, that is, somewhere between \$282 million and \$716 million. In view of the fact that no single value within these wide ranges is any more likely than any other, these estimates are too imprecise to justify any action. Due to these deficiencies in the sampling and audit procedures, EY concludes that “the amounts reported by the FCC as overstated investment are unsound and cannot be fairly relied upon.” In fact, when one considers the evidence that the SBC LECs submitted showing the existence of dozens of items that the auditors deemed “not found,” the low end of the 99% confidence interval would be below zero for both SWBT and Pacific.

There are also serious problems with the auditors’ rescoring standards described in the Rescoring Public Notice released on April 7, 1999. The Rescoring Public Notice claims that the evidence submitted by the RBOCs “often did not meet the standards to warrant rescoring.” It is fundamentally unfair and unreasonable for the auditors to expect the evidence to meet standards that are released for the first time seventeen months after the fact. On this basis alone, the auditors’ conclusions should be rejected.

While the auditors recognize the importance of direct physical examination in reaching their conclusion, their procedure was inconsistent because they did not return to any locations to perform any further physical examinations after receiving the RBOCs’ evidence showing that items originally scored “not found” actually existed. When presented with the companies’ proof that items existed, the auditors made no effort to communicate with the companies or to do any further investigation.

If the auditors truly considered these to be deficiencies at the time, the SBC LECs would have expected the auditors to communicate these deficiencies to the SBC LECs at some point during the several months during which this evidence was submitted to the auditors. Instead, the SBC LECs did not discover the results until they received the draft audit reports in July 1998 and even then they could only guess why the auditors rejected virtually all of their evidence. The auditors did not perform this audit consistent with Generally Accepted Auditing Standards (“GAAS”) because they did not consider all the evidence or perform all the procedures necessary under the circumstances. As EY explains, a “critical element of auditing is timely and frequent interaction with representatives of the company being audited to attempt to address issues raised in the audit.” If the auditors were not going to accept the evidence submitted by the companies, then they should have discussed this with company personnel and performed additional procedures necessary to evaluate the companies’ evidence. In any event, the auditors did not perform sufficient audit procedures and ignored relevant information.

The rescoring standards were also unreasonable and narrow. For example, the auditors rejected documentation that was not in the exact form required by its standards and documentation with nonmatching details despite reasonable explanations of the differences. While most items had very little chance of being rescored, embedded items originally scored “not found” had no possibility at all of being rescored. Besides, the auditors did not consistently follow their own standards. For example, even when exactly the same or very similar documentation was furnished on two different items, the auditors reached opposite conclusions.

In view of the serious flaws in the auditors’ sampling methods and audit procedures, these

audits cannot serve as a basis to require any corrective action. The audit reports produce extremely broad and imprecise estimates of the dollar value of allegedly “not found” equipment and ignore the evidence submitted by the companies. Besides, as the FCC requires ILECs to maintain CPRs in excessive and unnecessary detail, there must be some reasonable standard of materiality for evaluating compliance other than perfection or near-perfection. Further, the auditors used an unrealistically narrow and unprecedented interpretation of the rules in conducting these audits. Corrective action is not justified by these audits because the results are not reliable and the true degree of error in the CPR is not material.

Just as these audits do not justify corrective action generally, they also do not provide any rational basis for the auditors’ recommended write-offs. There is simply no statistically valid basis to conclude that the books of any RBOC are overstated by hundreds of millions of dollars, as alleged. Aside from the lack of justification, there are other problems with the write-off recommendation. First, writing off an extrapolated amount based on statistical analysis is contrary to Section 32.2000(d)(1)’s requirement that all retirements refer to the specific records in the CPR from which the required cost was taken. As a result, the companies would no longer be able to reconcile their CPRs with their books of account. Second, this recommendation is inconsistent with the reasoning of the second recommendation of complete inventories, in support of which the auditors claim that “the only way to ensure a CPR line-item is correct is to examine the corresponding equipment items.” Third, this recommendation does not consider all the changes that have occurred in the last two and a half years as a result of the RBOCs’ own physical inventory programs, such as the SBC LECs’ SAVR process, periodic inventory programs and routine

construction and replacement activity. For example, the auditors recommend that SWBT write off the \$924 million of undetailed investment that SWBT had as of June 1997, which fails to consider that the SAVR inventory process has already reduced this undetailed investment to about \$100 million. Obviously, it would be impossible to write off \$924 million when only \$100 million remains as undetailed. Fourth, write-offs as substantial as those recommended by the auditors should not be required where, as here, there has not been a fair consideration of all of the circumstances, such as the evidence submitted by the RBOCs.

Requiring a write-off of the undetailed investment also would be contrary to the FCC's December 1968 ruling that allowed the RBOCs to implement the mechanized CPR for hardwire equipment on a "going-forward" basis, that is, for plant added after the start of the plan in each region. The vast majority of the undetailed investment represents equipment that was placed in service before each RBOC implemented the mechanized CPR in a particular state or region. Thus, undetailed investment has been permitted by the FCC for 30 years. Applying cost/benefit considerations, the FCC should not impose onerous requirements to address the undetailed investment. Instead, it should recognize efforts such as those of the SBC LECs in identifying and eliminating this undetailed investment via the SAVR inventory process.

The audits should not be used as a basis to require any of the RBOCs to incur substantial, additional costs to inventory all of their central office equipment, as the auditors recommend. The benefits of such inventories are minimal or nonexistent. Delayed or omitted retirements discovered in any physical inventory would neither benefit nor harm ratepayers. In any event, the RBOCs' existing internal controls and procedures should be considered sufficient, such as the RBOCs'

inventories on a rotating basis over a period of years and the SBC LECs' SAVR inventory process. In the case of the SBC LECs, the auditors' recommended inventories are totally uncalled for, as they would duplicate the SBC LECs' SAVR process, in which independent contractors perform a comprehensive, two-way inventory of all hardwire equipment in each central office.

Given that the auditors did not even obtain a sufficient understanding of the companies' internal controls as part of these audits, as required by Generally Accepted Auditing Standards ("GAAS"), it is hard to see how they have any basis to recommend an independent audit of those controls. While such an independent audit is not justified on the basis of these audits, the SBC LECs are willing to consider reasonable, cost-effective methods of enhancing their internal controls, provided there is some material benefit in doing so. Given that the existing CPR requirements are excessively detailed and outdated, then, provided any review of internal controls is warranted after considering a sample review of the SAVR inventory process, the SBC LECs would be willing to consider engaging their existing independent auditor for the dual purpose of reviewing their internal controls as well as the FCC's CPR requirements. The purpose of reviewing the FCC's CPR requirements would be to recommend methods of streamlining and updating them.

Account balances and CPRs no longer play a role in ratemaking for price cap carriers, especially now that the FCC has eliminated sharing completely and also the low-end adjustment on a holding-company-wide basis for any price cap carrier that adopts any of the *Pricing Flexibility Order's* options in any of its markets. Even under rate-of-return regulation, delayed or omitted retirements would have little, if any, impact on ratemaking over time. The lack of impact is due to a combination of several factors explained in the Declaration of Marla Martin attached to these

Comments. Mainly, the retirement of an asset does not have any impact on the net plant balances and remaining life depreciation rates are self-correcting in nature. Thus, revenue requirements would not change materially and omitted or delayed retirements would not have any impact under rate-of-return regulation or under the rate-of-return backstop mechanisms of price cap regulation.

While there would not be any impact on the rate-of-return rates going into price caps in 1990, if we assume *arguendo* that there could be some impact, it would be inconsistent with the FCC's price cap regime to re-initialize the current price caps, especially now that the FCC has completely severed the connection between the prices customers pay and the costs that price cap carriers incur. To seek rate-of-return perfection long after the deadline for any challenges to 1990 rates would be inconsistent with the FCC's rejection of similar requests for revisions and further rate-of-return proceedings at the time. But, if the FCC were going to consider such adjustments, it would also need to address imperfections that caused the rates going into price caps to be too low.

It is important to understand that assets cannot be retired without identifying all of the individual units being retired, i.e., on the basis of a statistical extrapolation. Any individually identifiable units that cannot be found during a physical inventory should be handled as normal retirements. Just as a write-off would be improper, the Bureau's suggestion that these could be handled as extraordinary retirements is also wrong. These audits do not present a situation for which the extraordinary retirement rule was designed, such as when significant utility assets are destroyed by fire or other calamity. Nor do these audits satisfy the requirements of Section 32.2000(g)(4). First, delayed or omitted retirements resulting from inventories are not unusual. It is common to expect a number of inventory adjustments and retirements in connection with physical inventories that

utilities routinely perform. Second, one cannot say that these types of retirements are not reflected in depreciation studies or considered in the three-way meeting negotiation process. Among other reasons, it is extremely unlikely that such retirements would have altered any of the results of the give-and-take of that negotiation process. In any event, considering an RBOC's large depreciation reserves, there would not be a significant impact on any of the depreciation reserves.

There is also no reason to expect any causal relationship between inaccurate account balances and the results of the forward-looking cost models for universal service support and UNE prices. The forward-looking method of making these calculations generally do not rely on the ILEC's actual, embedded book costs. Consistent with the SBC LECs' experience, Ameritech shows that there are only two factors in its UNE cost studies that are affected by account balances: the maintenance and tax factors. However, if account balances have been overstated in recent years, as the auditors allege, these two cost factors and UNE prices were lower than they would have been otherwise. Thus, correction of any overstatements in the account balances would raise the rates paid by UNE customers.

Similarly, under the FCC's method of calculating the depreciation reserve deficiency, significant retirements of assets prior to them being fully depreciated would increase the size of this deficiency.

The FCC should consider these audits in a broader context that takes into account factors such as whether they are consistent with the cost/benefit analysis required by Section 11 of the 1996 Act and how they compare to the FERC's less burdensome asset tracking requirements. Increasing the burden of these regulations via comprehensive audits and unprecedented rule interpretations does

not make sense long after abandonment of rate-of-return regulation. Considering that these audits serve no useful purpose, they were performed in a manner that unduly intensified the burden of the CPR requirements at a time when the 1996 Act has made the streamlining and simplification of such outdated regulation a priority for the FCC. The FCC does not need such excessively detailed property records to perform its regulatory functions. Rather, the FCC should use this opportunity to consider methods of simplifying and updating these requirements.

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

In the Matters of

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

**COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY,
PACIFIC BELL AND NEVADA BELL¹**

Introduction

In 1994, four years after the FCC abandoned rate-of-return regulation in favor of price cap regulation for large Local Exchange Carriers ("LECs"), the FCC conducted a series of audits of the Continuing Property Records ("CPRs") of the Regional Bell Operating Companies ("RBOCs") including the SBC LECs. While the Common Carrier Bureau ("Bureau") prepared a consolidated report on these 1994 audits, it was never

¹ Southwestern Bell Telephone Company ("SWBT"), Pacific Bell and Nevada Bell ("SBC LECs") are filing these Comments pursuant to the Commission's *Notice of Inquiry*, 14 FCC Rcd 7019 (1999) ("NOI"), FCC 99-69 in the above-captioned proceeding released on April 7, 1999.

made public or furnished to any of the RBOCs.² In fact, some of the RBOCs did not find out the specific results of the 1994 audits until they received some of the details in the draft reports of the current audits four years later in July 1998.

Without ever concluding the 1994 audits, the Bureau initiated the current audits in 1997 using an entirely different approach. For example, instead of using a purely judgmental sampling process, the Bureau attempted to use a complex, two-stage stratified sampling process to select a sample of 36 pieces of equipment at numerous RBOC central office locations across the country. Over a period of two months in 1997, the FCC auditors fanned out across the SBC LECs' territory to conduct costly field audits on short notice at 64 central offices, spending typically no more than six to eight hours searching for the selected pieces of complex, technical equipment at each office. In late 1997, the FCC auditors furnished their preliminary results to the SBC LECs and, without any explanation, requested the companies' "perspective on the findings" within less than two-weeks.³ Considering that the total number of items in dispute at that time was almost 500, the SBC LECs were not able to furnish rebuttal on specific items within two weeks, but over the next several months, the SBC LECs spent thousands of hours investigating many of the items not considered "found" in the Bureau's preliminary results and furnished over 200 detailed write-ups proving the existence of the equipment using supporting records, data and documentation. Despite all of the evidence submitted by the

² SWBT Audit Report, n. 22. Please note, however, that Pacific Bell did receive two letters that included some of the results of the 1994 audit of Pacific Bell's central office equipment. *See, e.g.*, Letter dated April 11, 1994 from Jose-Luis Rodriguez, Chief, Audits Branch, FCC to Sheryl L. Herauf, Director, Federal Regulatory Accounting, Pacific Telesis Group – Washington. Pacific Bell responded with specific plans of action that addressed the FCC auditors' concerns. *See* Letter dated May 9, 1994 from Sheryl Herauf, Director, Federal Regulatory Accounting, Pacific Telesis Group – Washington to Jose Luis Rodriguez, Chief, Audits Branch, FCC.

³ *See, e.g.*, Letter dated Nov. 18, 1997 from Jeffery D. Stover, FCC Auditor, to B. Jeannie Fry, Director Federal Regulatory, SBC.

SBC LECs, the auditors never performed additional steps as required by auditing standards to confirm or understand the evidence submitted. The FCC's auditors rejected all but 35 of these write-ups, as the SBC LECs discovered for the first time when they received draft reports in July and December 1998. The SBC LECs had no idea precisely what standards the FCC auditors were applying to the write-ups the SBC LECs had submitted. In fact, the FCC auditors had not furnished a set of general standards until release of the Public Notice⁴ on the subject on April 7, 1999, some two years after the audit began.

Now, the NOI seeks comment on a number of fundamental questions relating to the validity of the auditors' findings, the validity and reasonableness⁵ of their audit procedures, whether accounting corrections are required, the merit of the audit reports' recommendations and the ratepayer impact of the audit results. Further, the NOI seeks comment on the evidentiary standards that the auditors claim to have applied to reject evidence such as the vast majority of SBC LECs' 200+ write-ups, which standards were disclosed to the SBC LECs for the first time when they were publicly released on April 7, 1999.⁶ Apparently, this release of written standards after the fact was in response to

⁴ Public Notice, "The Accounting Safeguards Division Releases Information Concerning Audit Procedures for Considering Requests by the Regional Bell Operating Companies to Reclassify or 'Rescore' Field Audit Findings of Their Continuing Property Records." DA 99-668, released April 7, 1999 (the "Rescoring Public Notice")

⁵ The reasonableness of the auditors' audit procedures is addressed in the context of the current CPR requirements. From a more general perspective even if the auditors had performed their work perfectly, these audit methods would still be unreasonable because the requirements are several times more onerous than they need to be in the current regulatory and competitive environment.

⁶ See Rescoring Public Notice, *passim*.

complaints from the SBC LECs⁷ and similar complaints from other RBOCs⁸ that they had never been furnished any written guidelines or standards and that the auditors' scoring and re-scoring suffered from numerous inconsistencies.

As part of their description of these and numerous other inconsistencies and flaws in these audits, the SBC LECs will elaborate to some extent on those that were identified in the SBC LECs' Response published with the audit reports.⁹ Not the least of these deficiencies is the obvious lack of planning of this audit, of which the NOI itself is a prime example. It is astonishing that the Bureau would devote so much time and effort, and require the RBOCs to devote equal or greater resources, to such comprehensive audits without knowing whether the results of the audits would have any practical utility. To leave that assessment of the value of an extremely costly and burdensome activity to the tail end of the entire process is irresponsible. However, similar "cart-before-the-horse" behaviors can be seen throughout the course of these audits, such as the failure to design the sampling method to produce accurate estimates of dollar values and, as an afterthought, the attempt to salvage the completely unreliable results with an ill-defined statistical method from the Bayesian family.

⁷ Joint Response of Nevada Bell, Pacific Bell and Southwestern Bell Telephone Company, filed Jan. 11, 1999, at 21-24 (the "SBC LECs Response") 21-24. The SBC LECs Response was published along with the Audit Report released Mar. 12, 1999. Other RBOCs' responses released on the same date will be cited herein in the same fashion (e.g., "Bell Atlantic Response")

⁸ See, e.g., Ameritech at 5-8 and Appendices A-O at 2-6 and A-4 at 1-7.

⁹ *Id.*

I. The Audit Results Are Unsound and Unreliable Due to Fundamental Flaws in the Auditors' Sampling and Audit Procedures (Issue 1).

A. Significant Deficiencies Plague the Audit Results, Especially the Dollar Estimates.

In Issue 1, the NOI seeks comments on the validity and reasonableness¹⁰ of the auditors' statistical sampling methodologies, including several subtopics such as the confidence intervals and the audit procedures. When the SBC LECs received the draft reports in July 1998, they retained the services of statisticians at Ernst & Young LLP ("EY") to review the methods used by the FCC auditors in these CPR audits. Based on the draft audit reports, EY prepared a report on each of the two audits of the SBC LECs. A copy of EY's report on Pacific Bell's CPR (the "EY Pacific Report") is attached to these Comments as Exhibit "A". As the EY reports explain in detail, there are four significant deficiencies in the methodologies used by the FCC auditors:

(1) Lack of Two-Way Audit. First, if the auditors wanted to accurately quantify the missing equipment, they should have conducted a two-way audit, instead of only checking to see whether an item in the CPR could be found in the central office. In effect, they only looked at "half of the equation."¹¹

(2) Sample Not Designed To Estimate Dollar Values Accurately. Second, the auditors designed the audit to measure the proportion of items not found, instead of the dollar value of missing items. The auditors' sample design causes the range of dollar estimates to be highly questionable and subject to significant uncertainty as evidenced by the huge size of the dollar confidence intervals.

¹⁰ The reasonableness of the auditors' audit procedures is addressed in the context of the current CPR requirements. From a more general perspective even if the auditors had performed their work perfectly, these audit methods would still be unreasonable because the requirements are several times more onerous than they need to be in the current regulatory and competitive environment.

¹¹ Bell Atlantic Response at 9.

(3) **Wide Margins of Error.** Third, the margins of error are very imprecise, and when they are corrected, using the SBC LECs' data, the margins of error are so wide that the results provide little or no useful information concerning the dollar value of property not found, especially when one considers that, as a statistical matter, no single value within the range is any more likely to be correct than any other.

(4) **Biased Estimates.** Fourth, there were many sources of bias that cause further inaccuracy in the audit results. Sources of this bias include substitution of items for undesirable ones and weakness in the audit controls.

EY describes the cumulative impact of these deficiencies as follows: "Given these errors and biases, the amounts reported by the FCC as overstated investment are unsound and cannot be fairly relied upon."¹²

Unfortunately, the SBC LECs cannot furnish a number that would represent an accurate estimate based on these audit results. Mainly, it is impossible to correct the audits' sampling and other problems after the fact. For example, given that the auditors estimate that the value of missing equipment at Pacific Bell is \$499.1 million \pm \$216.5 million, the range of values in the auditors' estimate is \$433 million, which is almost as large as the midpoint of the estimate's range. In fact, it is almost 90% of the auditors' \$499 million estimate. An estimate with such a wide range is not useful at all.

The range of the dollar estimate is so huge because of the way the auditors designed the audit. For example, after the auditors divided the central offices into eleven strata (in the SBC LECs' case), they did not select a sufficient number of central offices in each stratum.¹³

Even though one cannot produce a number that represents a corrected estimate that remedies all of the deficiencies in the auditors' sampling and other audit procedures,

¹² SBC LECs' Response, Attachment B, at 3.

¹³ See EY Pacific Report at 6. See also US WEST Response at 16.

it is clear that the auditors' estimates of the so-called "missing" equipment are significantly overstated for several reasons.

First. The failure to perform a two-way audit ignores equipment in the field that was not listed in the CPR. The result is that the audit reports' quantification of "missing" investment systematically overstates any value. That is, the auditors were looking for any equipment that might represent an overstatement while ignoring any equipment that would represent an understatement of the investment in the CPR. As the Deloitte & Touche statistician used by US WEST explains,

When tests are performed for both overstatement and understatement, understatement errors are often used to partially offset overstatement errors and therefore reduce the size of the resulting overstatement estimate.¹⁴

In fact, as part of the Statewide Asset Validation and Retirement ("SAVR") process, the SBC LECs have conducted two-way audits of its central offices and have found equipment that had not been posted in the CPR database. For example, as of August 31, 1999, SWBT's SAVR process had identified almost \$120 million of equipment that was not listed in the CPR. Further, in a two-way audit process, the auditors would not have counted an item as "not found" if the total quantity of like items at a location matched the total quantity in the CPR.¹⁵

¹⁴ US WEST, Attachment 2, Letter from Ann Thorton, Deloitte & Touche, dated Aug. 18, 1998, at 3.

¹⁵ A response to an inquiry from Congress attempted to explain why the FCC auditors had not conducted a two-way audit, although this appears to be an after-thought, given that the audit reports say nothing about this. This letter states, "Carriers have ample incentive to book all of these costs in the plant accounts because these accounts provide the basis for cost recovery through the ratemaking process." Letter dated Feb. 24, 1999 from William E. Kennard, to Hon. W.J. Tauzin and John D. Dingell, attachment at 3 ("Feb. 24, 1999 FCC Letter to Congressmen Tauzin and Dingell"). Of course, a presumed incentive is no reason for an auditor to skip half of the procedures required to

Second. The huge margin of error in the dollar estimates discussed above makes it impossible to rely on the auditors' estimates. A 40% to 50% margin of error is certainly too imprecise to justify any CPR or accounting adjustments – even if that were the only flaw in the auditors' method. And, in view of the fact that no single value within these wide ranges is any more likely to be correct than any other, auditing standards such as those used by the IRS¹⁶ would use the low end of the confidence interval. And, EY recommends using a 99%, rather than a 95%, confidence interval “to balance the bias that is inherent in the audit.”¹⁷ The use of a more conservative 99% interval is especially necessary given the significant uncertainty created by the sample design that does not consider dollar values. As a result of these corrective adjustments alone, the auditors' estimates are reduced from \$499 million to about \$180 million for Pacific Bell and from \$221 million to about \$-40 million for SWBT.¹⁸ If, in addition, one considers that the

reach an accurate conclusion. Besides, booking of costs is an operational task that is dependent on manpower, systems, supplier data, technology turnover, internal controls and similar factors. In fact, the auditor does not know how much incentive, if any, a particular carrier has and whether its employees' actions would, in fact, be driven by that incentive. Further, there are many variables other than motive that could affect the accuracy of bookings, such as the accuracy of data furnished by suppliers. Thus, the auditor cannot assume the nonexistence of half of the equation, especially without reviewing and testing internal controls as part of the audit. Even if such an incentive could play a role, the FCC's response fails to consider the significantly reduced incentive for carriers to be concerned about booked costs because of price cap regulation without rate-of-return backstop mechanisms. Under this form of regulation, there is no expectation of cost recovery through a ratemaking process as discussed under Issues 8 below.

¹⁶ EY Pacific Report at 11; Bell Atlantic Response at 11; US WEST Response, Attachment 2, Letter from Ann Thorton, Deloitte & Touche, dated Aug. 18, 1998, at 3.

¹⁷ Bell South Response at 21. *See also* EY Pacific Report at 11-12.

¹⁸ The auditors use the midpoint of the confidence interval as their estimate of the plant balance overstatement (\$499 million for Pacific Bell and \$221 million for SWBT). For the reasons discussed in the text, EY uses a one-sided lower confidence bound which

number of items considered “not found” should have been reduced from 198 to no more than 106, based on the evidence the SBC LECs submitted, the low end of these confidence intervals would be below zero for both SWBT and Pacific Bell.¹⁹

Third. The other sources of bias further undermine the value of the estimates. While it is hard to quantify the impact of these bias factors, their impact should not be ignored. For example, bias is introduced by the auditors’ poorly planned and conducted field audits, and subsequent procedures. A number of factors contributed to this nonsampling error, such as the lack of training and coordination among the FCC audit teams; lack of consistent, written guidelines for handling problems or contingencies in the field; failure to provide practical written field instructions; failure to have a complete understanding of the SBC LECs’ practices, procedures and controls prior to conducting the field visits; failure to review the SBC LECs’ SAVR inventory process as part of this audit; the significant number of changes in the field results soon after the field work but without going back to any locations to check the quality of the initial field work; the substitution of locations that were deemed impractical to audit and of items that were deemed “hard-to-get-to”; the failure to allow sufficient time to conduct a thorough review of all 36 items at every location; and the lack of consistent, contemporaneous written guidelines for rescoreing field results based on evidence submitted by the audited RBOC.²⁰

To illustrate just one of these sources of bias, consider the rescoreing by the auditors during the field audits and shortly afterwards back at the FCC offices. Often, the

yields \$180 million for Pacific Bell and \$-40 million for SWBT. EY Pacific Report at 11-12 & 21.

¹⁹ EY Pacific Report at 21.

²⁰ For further discussion of these sources of bias, see SBC LECs Response at 11-17.

two auditors would consult with each other during the field audit to revise scores. Then, back at the FCC offices scores were revised again. In this post-field audit rescoring, over 12% of the items were rescored across all the audit teams that audited the SBC LECs and one of the audit teams had over 45% of its scores revised back at the FCC offices.²¹ These facts indicate that the standards of review were ill-defined or not defined at all in advance. Further, it is not quite as troubling that the auditors revised their scores on-site while they could still visually check the equipment as the fact that the auditors made numerous changes based on their notes alone back at the office. At a minimum, the auditors should have returned to a sub-sample of locations to determine whether changes were being made appropriately.²² As EY explains,

The audit staff tried to correct this control problem by making extensive “back-at-the-office” changes in the scores. It is unclear whether they succeeded in addressing the original team variability in approach since no locations were revisited to verify that the back office scoring correctly represents the true state of the property records.²³

While the impact of these sources of bias on the audit results cannot be precisely measured in all cases, the degree of difference between the auditors’ scores and the audited companies’ scores reflects the amount of bias inherent in the auditors’ procedures. For instance, the following are the number of items scored as “not found” by the auditors compared to the RBOCs’ own documented findings:

²¹ SBC LECs Response at 15 and Attachment A.

²² See SBC LECs Response at 15 and Attachment B, at 3; BellSouth Response at 12.

²³ Bell Atlantic Response, Exhibit 2, at 5. Other reasons exist to make a second visit, such as the unavailability of supporting documentation for some items at the time of the field visit. Given the difficulty of furnishing documentation for one of thousands of line items on a couple of hours’ notice on the day of the field visit, the auditors should have been more willing to accept documentation submitted after the field visit.

	<u>FCC “Not Found”</u>	<u>Difference</u>	<u>BOC “Not Found”²⁴</u>
SBC LECs	198	92	106
Ameritech	140	32	108
BellSouth	116	32	84
US WEST	123	75	48

As these numbers show, there is a significant difference in the number of line items, and the difference is even greater if one considers the value of items “not found.” The greater difference in the dollar values is due in part to the greater incentive that the audited RBOC personnel have to find higher value items. As an example, for Pacific Bell, the difference between the auditors’ scores and the company scores reduces the auditors’ estimate by about \$375 million, a 75% reduction, compared to about a 50% reduction in the number of items (from 113 to 58).²⁵ When the disparity between two sets of results is this large, standard auditing procedures prescribe that additional procedures be performed to obtain adequate assurance regarding the auditors’ conclusions. Thus, the FCC auditors should have sought to discuss their preliminary results with the companies and obtained clarification of the documentation submitted. Strangely, however, in this audit, the FCC auditors made no attempt to discuss the SBC LECs’ write-ups with company personnel. Failing to obtain sufficient evidence or information to resolve conflicting data is contrary to Generally Accepted Auditing Standards and further demonstrates the bias inherent in this audit.²⁶

²⁴ The sources of these numbers are the RBOCs responses.

²⁵ EY Pacific Report at 16.

²⁶ In fact, instead of seeking to discuss and obtain further information about the documentation that the SBC LECs were submitting, the FCC auditors attempted to cut off further submissions before the SBC LECs had an adequate opportunity to research and respond to the preliminary results of the field visits. *See* Letter dated Jan. 27, 1998 from

Fourth. In addition to being inflated and utterly unreliable as a result of the foregoing flaws in audit methodologies and procedures, the auditors' estimate of the value of "missing" equipment they would have the companies write off is exaggerated because it does not consider the impact of accumulated depreciation. That is, the audit reports' figures are too high because they are stated in terms of gross, rather than net, book value. Specifically, the gross book value of the 198 items the auditors classified as "not found" at the SBC LECs was \$1.9 million compared to a net book value of \$746,000 for these same items. This represents a 60% reduction in the face value of the amount of equipment considered not found. By using gross book values to extrapolate the results, the FCC auditors further overstated the significance of the potential discrepancies.

Even the Florida Public Service Commission ("Florida PSC") recognizes that "the validity of the sample was compromised" and concludes that "the sample results should not be extrapolated to the population."²⁷ In fact, the Florida PSC notes that another problem with the sample design is that it was not designed to produce accurate estimates at the state level.²⁸ While each of the audit reports was careful to point out that "all of the states in which [the RBOC] operates were represented in the sample,"²⁹ the auditors did not properly design the sample to be representative by state. For example, as the Florida PSC explains, the auditors added a single central office location in North Carolina after the fact.³⁰ If the auditors wanted results that could be used at the state level, they should

Ken Ackerman, Chief, Audits Branch, FCC to B. Jeannie Fry, Director—Federal Regulatory, SBC.

²⁷ Florida PSC Comments, CC Docket No. 99-117, filed June 7, 1999, at 3.

²⁸ *Id.*

²⁹ *See, e.g.*, Bell Atlantic (South) Audit Report, Appendix B, at 6(emphasis added).

³⁰ Florida PSC Comments, CC Docket No. 99-117, filed June 7, 1999, at 3.

have used a method such as state stratification. The Florida PSC finds this problem because of the omission of North Carolina in the initial sampling results for BellSouth, but it is not an isolated problem. As the SBC LECs Response explained, this problem is also evident in the auditors' handling of Oklahoma and Nevada in the SBC LECs' region.³¹

The sample results simply cannot be accurately extrapolated to the entire population. As the foregoing shows, after compensating for the severe deficiencies in the sampling methods and using the companies' corrected scores for the "not found" items, the resulting dollar estimate for the "not found" items are very low or below zero. In view of these deficiencies and the highly uncertain audit results, it is apparent that the audit results are extremely unsound and cannot be relied upon for any purpose.

B. The Poorly Explained Bayesian Method Cannot Remedy the Fundamental Flaws in the Sample Design and Audit Procedures.

Much like the auditors' other after-thoughts, the brief and ill-defined description of the auditors' Bayesian statistical analysis was added to the second draft of the audit reports that were furnished to the companies near the end of 1998. The audit reports explain that this Bayesian analysis was added to corroborate the auditors' original findings that used a classical statistical analysis,³² but, it would be more precise to say the Bayesian analysis was added in response to the RBOCs' criticisms of the classical statistical analysis in the July 1998 draft audit reports. In Appendix B of the audit reports, the one-page description of the FCC auditors' Bayesian analysis is much shorter than the step-by-step fifteen-page description of their classical analysis. Whereas formulas and step-by-step procedures are included for their classical analysis, very little

³¹ SBC LECs Response at 16-17.

³² See, e.g., SWBT Audit Report, Appendix B, at 16.