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

In the Matter of	)	
	)	
1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers	)	CC Docket No. 98-137
	)	
Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit, *et. al.*	)	CC Docket No. 99-117
	)	
GTE Telephone Operating Companies Release of Information Obtained During Joint Audit	)	AAD File No. 98-26

COMMENTS OF AT&T CORP.

Pursuant to the *Further Notice* in the above-captioned proceeding,[1] AT&T Corp. ("AT&T") hereby submits its comments concerning the Commission's proposal to codify in its depreciation prescription rules the proposals by certain price-cap incumbent local exchange carriers ("LECs") that they be granted waivers of those rules without the protections to guard against adverse impacts on consumers and competition that the Commission recently ruled are necessary to justify such waivers.[2]

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[1] Further Notice of Proposed Rulemaking, *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers,* CC Docket Nos. 98-137, 99-117, AAD File No. 98-26 (April 3, 2000) ("*Further Notice*").

[2] *See* March 3, 2000 Letter from Robert T. Blau, Vice-President-Executive and Federal Regulatory Affairs, BellSouth, to Ms. Magalie Roman Salas, Secretary, Federal Communications Commission ("*March 3 LEC Letter*").

INTRODUCTION AND SUMMARY

Just three months ago the Commission concluded its year-long review of its depreciation prescription rules for price-cap incumbent LECs. *See* Report and Order, *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers,* CC Docket Nos. 98-137 et al. (December 30, 1999) ("*Depreciation Order*"). Noting "the significantly harmful impact that unrestricted changes in depreciation expenses could have on consumers and competition" as well as the "serious consequences" that failure to enforce the depreciation rules would pose "for the universal service process," the Commission rejected the price-cap LECs' request that the Commission forbear from applying key depreciation regulations. *Id.* ¶¶ 29, 30. As the Commission explained: "it would not be in the public interest to waive our depreciation rules with the issue of billions of dollars in potential claims unresolved." ¶ 35.

Recognizing that there may be some limited circumstances in which waivers of the depreciation prescription rules could be appropriate, however, the Commission provided a well-crafted checklist of conditions under which it could find an individual carrier's waiver request in the public interest. In particular, the Commission found that a waiver "*may* be approved" when an incumbent LEC: (1) immediately "adjusts the net book costs on its regulatory books to the level *currently* reflected in its financial books," (2) makes that adjustment "by a *below-the-line* write-off," (3) "uses the same depreciation factors and rates for both regulatory and financial accounting purposes," (4) "foregoes the *opportunity* to seek recovery of the write-off," and (5) "agrees to submit information concerning its depreciation accounts, including forecast additions and retirements for major network accounts and replacement plans for digital central offices." *Id.* ¶ 25 (emphasis added). Although the Commission noted that it would consider alternative waiver proposals, it stressed that any such alternative "*must* provide the *same* protections to

guard against adverse impacts on consumers and competition as the conditions adopted in this Order provide." *Id.* (emphasis added); *see also id.* n. 77 (alternatives can be considered only "if they are designed to achieve the *same* protections we seek to assure with the waiver mechanisms described herein") (emphasis added).

The *March 3 LEC Letter* state those carriers' intention to jointly file for waiver of the Commission's depreciation standards in conjunction with the CALLS plan for universal service and access reform.[3] The LEC waiver proposal differs markedly from the criteria just established by the Commission to "provide assurance that carriers do not engage in a practice that would disadvantage consumers and competition." *Id.* ¶ 26. First, rather than an immediate write-off, the LECs propose a five-year amortization; rather than a below-the-line write-off, the LECs propose an above-the-line write-off; rather than the specific depreciation information noted by the Commission, the LECs propose to submit unspecified "information" about the depreciation practices and then only when undefined "significant changes" are made.[4] Second, the alternative protection proposed by the LECs – a "pledge" not to seek recovery of this depreciation reserve amortization in interstate rates – would require constant Commission oversight to ensure that the LECs do not intentionally or unintentionally shift to customers some of the proposed amortization, a result that would be precluded by the Commission-sanctioned approach of using the structural device of an immediate, below-the-line write-off, coupled with its already in-place

[3] *See* Public Notice, *Coalition for Affordable Long Distance Service ("CALLS") Modified Proposal*, CC Docket Nos. 99-262 *et al.* (March 24, 2000). The LECs' March 3 proposal is not part of the CALLS plan.

[4] *March 3 LEC Letter* at 1-2.

and well-tested accounting safeguards, to foreclose any such improper cost-shifting with respect to either interstate or intrastate rates.[5]

Regardless of the Commission's treatment of these requested changes in its depreciation rules, however, the Commission should not conclude that reconciling the LECs' regulatory accounting books with their financial accounting books would moot resolution of, or further Commission proceedings on, its auditors' findings that the LECs have included billions of dollars of missing central office equipment in their continuing property records ("CPR"). AT&T agrees that *prospective* interstate access rates proposed by the CALLS plan are appropriate irregardless of the ultimate disposition of these past amounts of missing equipment, and that nothing that happens in this proceeding or the CPR audit proceeding should affect either the end-points or the "glide path" contemplated by the CALLS plan. However, the LECs' asset overstatements almost certainly caused a substantial inflation in access charges *in past years*. That cannot possibly be cured by a prospective write-off, and corrective action for past years' charges by the Commission in the CPR audit proceeding is both necessary and consistent with implementation of the CALLS plan on a prospective basis.

ARGUMENT

I. THE BLANKET DEPRECIATION WAIVER SOUGHT BY THE INCUMBENT LECS WOULD NOT SERVE THE PUBLIC INTEREST.

As the Commission explained in the *Depreciation Order* and reiterated in the *Further Notice*, the waiver guidelines the Commission just established reflect both critically important Commission policies and the economic realities of depreciation accounting. "Depreciation constitutes 28 percent of incumbent LECs' total operating expenses, and is their largest single

[5] Because the LECs have close to three times as much plant separated into the intrastate jurisdiction as the interstate jurisdiction, monitoring and enforcing this LEC pledge would

expense." *Depreciation Order* ¶ 3. For that reason, the Commission has consistently recognized the need "to assure . . . that any changes in depreciation practices do not adversely impact consumers and competition." *Further Notice* ¶ 3.

The Commission's depreciation rules are designed to discourage both deliberate and inadvertent manipulation that harm consumers and competition and, accordingly, *any* dominant carrier request to modify those rules, and the consumer protections they afford, must be carefully evaluated. The Commission recognized as much in the *Depreciation Order* in establishing bright-line criteria designed to make transparent any deliberate or inadvertent attempt by a waiver recipient improperly to profit from a change in its depreciation practices.

Thus, the Commission urged a waiver proponent to agree to an immediate reconciliation of financial and regulatory books with a one-time, below-the-line adjustment that would have the support of all of the Commission's in-place and well-tested accounting safeguards to make it very difficult for a write-off or any other changes in depreciation expense to impact rates. The current LEC proposal, in contrast, contemplates above-the-line adjustments strung out over five years. Under existing rules, that treatment would not only qualify the adjustments for inclusion in rate calculations but would for five years provide regulators and intervenors an obscured set of books and regulatory reports with which to monitor and enforce LEC adherence to their pledge *not* to do (increase intrastate or interstate rates) what these books and regulatory reports would otherwise suggest that they *could* do (increase rates). *See Depreciation Order* ¶ 28 ("The harmful impact that increased charges could have on competition is . . . substantial"). *See also*

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necessarily have to rely on the efforts of fifty state PUCs in addition to the Commission.

Further Notice ¶ 12 ("Prominent among these conditions was a requirement to write-off, below-the-line").[6]

The LECs' pledge to "agree" that the proposed amortization "would have no effect on interstate price caps or their interstate rates" and "commit not to seek recovery of the interstate amortization expense through any rate action at the state level," *March 3 Letter* at 2, is simply inadequate. The *Depreciation Order* itself recognized that more is required – the Commission there included as conditions *both* a promise not to seek recovery *and* the one-time, below-the-line adjustment designed to make that promise meaningful.[7] As the Commission has explained, the promise, "*in conjunction with* the first and second conditions, was intended to ensure that customers would suffer no adverse rate impacts should a carrier employ new depreciation methods." *Further Notice* ¶ 7 (emphasis added).

Put simply, any changes to the Commission's depreciation prescription rules adopted in this proceeding must provide the same measure of protection to customers as the waiver conditions set out in the Commission's *Depreciation Order*.[8] The current LEC proposal would instead place the burden on the Commission, fifty state PUCs and customers to monitor and

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[6] Moreover, as the recent audits have demonstrated that much of the equipment in question appears not to exist at all (or was long ago retired), it is difficult to imagine any basis for delayed amortization, as opposed to an immediate write-off.

[7] The difficulty of enforcing the promise is particularly acute given the need for five years of monitoring by the Commission and by each of the fifty state PUCs – as well as the waiver proponents' extremely weak nod to the Commission's information disclosure condition – a vague promise only to submit unspecified "information concerning their depreciation accounts when significant changes to depreciation factors are made." *March 3 LEC Letter* at 1.

[8] As the *Further Notice* recognizes (¶ 14), accurate, up-to-date depreciation information continues to be necessary both in determining the costs of universal service and in determining network element costs. Accordingly, no depreciation rule revisions should permit an incumbent price-cap LEC to discontinue maintaining and submitting, subject to appropriate confidentiality protections, up-to-date depreciation information for all major accounts.

detect any improper shifting of write-off costs, and to devise alternate regulatory protections crafted to operate using books of account that no longer represent the Commission's views of appropriate depreciation and capital accounting. In short, a mere pledge, which would inevitably lead to years-long regulatory battles at the Commission – and require the Commission to monitor all state rate proceedings to ensure compliance with the pledge "not to seek recovery of the interstate amortization expense through any rate action at the state level," *March 3 LEC Letter* at 2, falls far short of the well-founded, well-defined rules and associated enforcement mechanisms that the Commission has already established. Without such safeguards – and the *March 3 LEC Letter* does not identify any – the Commission cannot conclude that the LECs' proposal satisfies the *Depreciation Order's* requirement that alternative waiver proposals "provide the *same* protections to guard against adverse impacts on consumers and competition as the conditions adopted in this Order provide." *Depreciation Order* ¶ 25 (emphasis added). *See also Further Notice* ¶ 9.[9]

II. NEITHER THE 5-YEAR AMORTIZATION CONTEMPLATED BY THE LECS' WAIVER PROPOSAL NOR ANY OTHER PROSPECTIVE WRITE-OFF COULD WARRANT TERMINATION OF THE CPR AUDIT PROCEEDINGS.

In Docket No. 99-117, the Commission is currently considering what corrective actions may be appropriate in response to the Commission staff's CPR audits that found that, combined, the Regional Bell Operating Companies "could not account for approximately $5 billion of central office equipment." *Further Notice* ¶ 15. To be sure, the LECs' waiver proposal confirms that the Commission should adopt the staff's recommendation "that these amounts be written-off the RBOCs' regulatory books of account." *Id.* And, if the CALLS plan is adopted, neither the

[9] The *March 3 LEC Letter* was filed on behalf of price-cap LECs that are parties to the CALLs proposal, and the Commission's resolution of those LECs' proposal in this proceeding should in no way affect depreciation regulation of LECs that are not parties to the CALLS plan.

proposed five-year amortization nor appropriate resolution of the CPR audit proceeding will affect the end point for access rates of participating LECs or the trajectory upon which those rate levels are implemented. But such a prospective write-off will in no way render the audit findings or the need for further Commission action on those findings "moot." *Id.*[10]

As AT&T and others have demonstrated in the CPR audit proceeding, overstatement of CPR has produced overstatement of rates, even under the Commission's current incentive ratemaking approach.[11] Although an immediate prospective write-down is surely warranted and could remove the impact of CPR overstatement on future rates, neither a write-down nor the proposed amortization would remedy the serious rate overcharges incurred in past years as a result of the CPR overstatement. Thus, regardless of what the Commission does in this proceeding and regardless what steps the RBOCs take in the future to remedy their CPR overstatements, there is no reasoned basis to terminate the CPR audit proceedings. Rather, the Commission should expeditiously conclude those proceedings by determining appropriate corrective action to remedy the past harms caused by the RBOCs' CPR overstatement.[12]

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[10] Because about three quarters of LEC plant is separated into the intrastate jurisdiction, overstatement of CPR has produced overstatement of intrastate rates as well as interstate rates.

[11] *See* Comments of AT&T, CC Docket No. 99-117 at 31 (filed September 23, 1999) (public version attached hereto as Appendix A); Reply Comments of AT&T, CC Docket No. 99-117 at 35-43 (October 25, 1999) (public version attached hereto as Appendix B).

[12] In addition, it should be noted that any Commission decision on these CPR audits or on a depreciation reserve deficiency write-off or amortization should have no effect on the access rates proposed on a prospective basis in the CALLS plan.

CONCLUSION

For the foregoing reasons, the Commission should deny the incumbent price-cap LECs' waiver proposal.

Respectfully Submitted,

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April 17, 2000

APPENDIX A

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 Telephone Companies' Continuing Property Records Audit	)	
Southwestern Bell Telephone Company's Continuing Property Records Audit	)	
US West Telephone Companies' Continuing Property Records Audit	)	

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Before the
FEDERAL COMMUNICATIONS COMMISSION
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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
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Southwestern Bell Telephone Company's Continuing Property Records Audit	)	
US West Telephone Companies' Continuing Property Records Audit	)	

COMMENTS OF AT&T CORP.

Pursuant to the Commission's *Notice*,[1] AT&T Corp. ("AT&T") hereby submits its comments concerning the accounting practices of the captioned companies, and the issues arising from the audits of their hard-wired central office equipment ("HWCOE") by the Common Carrier Bureau Staff ("Staff").

[1] Notice of Inquiry, *Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit*, 14 FCC Rcd. 7019 (1999) ("*Notice*").

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These comments are, of necessity, preliminary. Bell Atlantic only recently permitted the Commission to disclose the work papers underlying the Commission and Bell Atlantic analyses of the audits to AT&T and other interested parties. The other holding companies that challenge the Commission's audit results – Ameritech, BellSouth, Pacific Bell/Nevada Bell, Southwestern Bell and U S WEST – still refuse to permit others to inspect the property records and other work papers needed to test their criticisms of the audit results. Due process entitles ratepayers and other interested parties an adequate opportunity to review, analyze and respond to these workpapers. Accordingly, these comments focus primarily on the Bell Atlantic audits and criticisms. AT&T reserves the right to supplement these comments within a reasonable period after Ameritech *et al.* permit the workpapers and other materials underlying their audit results to be examined.

INTRODUCTION AND SUMMARY

The release of the Staff's reports of the Commission's audits of the HWCOE records of the Regional Bell Operating Companies ("RBOCs") understandably has received much attention in the press, at the Commission, and on Capitol Hill. Both the magnitude of the errors uncovered and their striking similarity from RBOC to RBOC were shocking. These audits suggest that literally *billions* of dollars of investment on the RBOCs' books reflect equipment either never placed in service or long since retired.

Rather than allowing interested parties to examine the data underlying these audit results and cooperating with the Commission to determine an appropriate solution, the RBOCs have responded by orchestrating a massive public relations campaign against the credibility of the Commission and its audit Staff. But the welter of criticisms mounted by Bell Atlantic and its peers concerning the adequacy of the audit procedures and the professionalism of the

Commission's audit Staff cannot obscure the enormity of the noncompliance that the audit Staff has discovered. The critical facts are beyond serious dispute.

First, accurate property records remain the foundation of any meaningful effort to constrain the RBOCs' ability to exploit their enduring monopoly power over ratepayers. The advent of incentive regulation has not severed this link. Incentive ratemaking replaced traditional cost-of-service ratemaking only recently for many of the services provided by Bell Atlantic and other RBOCs, particularly at the state level. Moreover, incentive ratemaking produces just and reasonable rates only if the initial rates that served as the starting point of the price cap process were themselves just and reasonable. If the starting rates were the product of a regulatory rate base inflated with phantom assets and phantom costs, every successor rate has been inflated as well. And, as described below, misrepresentation of equipment costs has numerous other real-world rate impacts arising from excess profit sharing requirements and other features of incentive ratemaking.

Second, the burden of proving that the RBOCs' continuing property records ("CPR") are limited to assets that are actually used and useful rests on the RBOCs themselves. The RBOCs—not the Commission, state regulators, ratepayers or third parties—control the acquisition, management and retirement of the RBOCs' central office equipment; dictate what items are credited and debited in the RBOCs' property records and accounts; and hire, supervise and fire the employees responsible for ensuring the accuracy of those records. The scale of the RBOCs' operations, the multiplicity of their offices and assets, and the limited enforcement resources available to the Commission effectively relegate it to a secondary role. Limited access to RBOC data likewise handicaps the enforcement efforts of third parties.

Third, the RBOCs' assault on the sampling procedures underlying the audits is without substance. The stratified sampling procedures were designed by accounting and statistical experts on the Commission's Staff, adhered to widely used and generally accepted sampling practices, and were reasonably calculated to produce accurate and reliable results. The auditors' exclusion of extremely small or inaccessible offices, and their decision not to perform two-way audits, do not warrant a contrary conclusion. Excluding small or inaccessible offices could significantly affect the results only if a significant share of property assets were located in those offices *and* the incidence of missing equipment at those offices differed significantly from the incidence at other offices. Likewise, failing to estimate the number or value of actual assets that are *omitted* from the RBOCs' accounts could significantly affect the results of the audit only if a significant number of existing assets were missing from the corporate books. The RBOCs are in the best position to show that any of these conditions hold, and have an obvious incentive to do so. The only plausible inference from their failure to make such a showing is that the effect of these omissions is immaterial, or that the audit Staff's sample *understates* the overall percentage of HWCOE that is missing.

Fourth, Bell Atlantic's critique of the audit Staff's scoring and rescoring procedures is equally misguided. Even Bell Atlantic admits that it cannot find three percent of the items selected for verification by the audit Staff. *See Response To Audit Draft Report of Findings related to Audit of Continuing Property Records of Bell Atlantic* at 1, CC Docket No. 99-117 (Jan. 11, 1999) ("Bell Atlantic"). Moreover, any bias in the scoring standards was in Bell Atlantic's favor. The audit Staff bent over backwards to give the RBOCs an opportunity to demonstrate that items on the companies' books actually remained in service, even scoring items as "unverified" that should have been reported as missing. Likewise, Bell Atlantic's criticism of

the *rescoring* procedures amounts to little more than dissatisfaction that the audit Staff declined to accept on faith all of Bell Atlantic's after-the-fact speculation about the whereabouts of missing assets. The audit Staff had no duty to do so. Items entering the rescoring process were, by definition, assets that neither the audit Staff nor Bell Atlantic's own employees could locate during the field visits. Under the circumstances, it would have been arbitrary for the audit Staff *not* to demand a reliable paper trail before accepting Bell Atlantic's belated claims about the provenance and disposition of the assets. **[***BEGIN PROPRIETARY***]**

[*END PROPRIETARY***]**

Fifth, Bell Atlantic's criticisms of the statistical point estimates and confidence intervals obtained by the audit Staff are without merit. Phantom assets in the property accounts cause an unlawful transfer of resources from ratepayers to the RBOCs. The most evenhanded way to restore the proper economic balance between the two groups is a rate base reduction equal to the *best* estimate of the amount of the overstatement. There is no legal or economic justification for setting the adjustment equal to the lower (or, conversely, the upper) end of the confidence interval surrounding the point estimate. In any event, Bell Atlantic has grossly overstated the breadth of the relevant confidence interval. The confidence interval most commonly used in major statistics-based regulation and litigation is 95 percent, not 99 percent. And here, the *reducto ad absurdum* of the RBOCs' statistical arguments is their claim that the bottom of the confidence interval is below zero. This is an arithmetic impossibility. Because multiple items in the sample were missing (as even Bell Atlantic concedes), at least as many items were missing from the population from which the sample was drawn.

Sixth, the only options lawfully open to the Commission are reducing the RBOCs' rate bases by the share of phantom assets (and requiring related adjustments to the RBOCs' books), or sponsoring a full-blown audit of each RBOC (and requiring similar audits in the future).[2] Simply sweeping the evidence under the rug, as Bell Atlantic proposes, is no answer at all: the evidence strongly indicates that the RBOCs have maintained inflated books (either willfully or through neglect), and are bilking their customers of millions of dollars annually as a result.

I. THE STANDARD SAMPLING TECHNIQUES EMPLOYED BY THE STAFF WERE VALID AND PROPER.

Bell Atlantic and the other RBOCs raise a host of conjectural challenges to the design and methodologies used by the Staff to determine the proportion and dollar value of missing HWCOE. In so arguing, the RBOCs grossly mischaracterize the qualifications of the Staff and the soundness of the audit procedures employed by the Staff. In fact, the Staff was comprised of experienced and professional statisticians, engineers and accountants. And the statistical procedures implemented by the Staff are well-accepted and commonly employed by statisticians and auditors in similar circumstances.

A. The Audits Were Performed By Qualified, Professional Staff.

It is regrettable that discussion of the audit procedures must begin with a defense of the audit Staff's professionalism. Bell Atlantic's attacks on the competence and credibility of the audit Staff are unfounded and shameful.[3] The Staff were experienced and capable professionals assembled by the Accounting Safeguards Division of the Commission's Common Carrier

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[3] *See, e.g.*, Bell Atlantic at 1 ("information inexplicably appears); *id.* at 2 ("staff did little more than shuffle around the categori[es]"); *id.* at 10 ("inspectors . . . were never given the opportunity to understand what they were inspecting").

Bureau. The team included 29 accountants (most of whom are certified public accountants), two engineers, an expert statistician, and five attorneys. The accountants had over 550 years of cumulative professional expertise, including over 290 years of experience in auditing or accounting for telephone carriers. The engineers included the Division Chief, who is a professional engineer with over 28 years of experience addressing engineering and accounting issues, and the Division's Chief Engineer, who has over 43 years of telecommunications engineering experience. The Division's statistical expert holds a bachelor's degree in mechanical engineering, master's degrees in electrical engineering and operations research, and a Ph.D. in physics. He has over 30 years of experience in statistics and network engineering, including 12 years of experience in testing HWCOE. This team and its supervisors (not including Division level review and Legal Branch activities) devoted approximately *4,800 hours* to each RBOC audit.

B. The Audits Followed Established Statistical Procedures.

The Staff's statistical procedures reflected their professionalism. The task facing the Staff was daunting: to determine the accuracy of CPR records detailing hundreds of thousands of individual pieces of equipment scattered throughout the country. The RBOCs concede that it would have been impractical for the Staff separately to verify each item in these circumstances.[4] This is a common problem in audits of large organizations, and the Staff responded with a well-accepted solution: a "two-stage stratification" sampling process designed to provide a precise estimate of the proportion and value of missing HWCOE.

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[4] *See* Bell Atlantic at 24 ("the costs of such an inventory would be between 50 and 100 million dollars").

Two-stage stratified sample designs are commonplace in government and other surveys *See, e.g.*, William G. Cochran, *Sampling Techniques* 292 (3rd ed. 1977); Affidavit of Robert M. Bell ("Bell Aff.") ¶ 12 (attached hereto as Ex. B). The scientific community recognizes this established technique as a rigorous, flexible and cost effective method of accurately estimating the characteristics of large populations of varying size. *Id.*

A two-stage stratification plan was particularly appropriate here, for the RBOCs' central offices are spread throughout the United States. Field audits are costly undertakings for both the Commission and the host RBOC, and a large share of these costs (*e.g.*, travel, setup, and administrative costs) are unaffected by the number of items inspected at a particular site. A two-stage stratification method increases the efficiency of an audit by permitting the inspection of multiple CPR items at each site visited. It would be inefficient to employ a simple random sampling method where only one CPR item might be chosen for on-site inspection at a particular central office. Thus, the two-stage stratification methodology allowed the Staff to collect much larger samples than could have been collected for the same cost with simple random sampling. *See* Bell Aff. ¶ 11.

In a textbook application of the two-stage stratified sampling technique, the Staff collected information about 36 CPR line items for each central office selected. In stage one, the Staff chose a random sample of the central offices from each stratum, *i.e.* grouping of central offices by size. Because small offices are more numerous than large central offices, this ensured that large offices (where most HWCOE is located) were adequately represented in the audit. And because a fixed number of items was sampled from each central office, equipment in large offices was properly sampled in roughly the same proportion as it exists in the population as a

whole.[5] In stage 2, the Staff randomly selected 36 line items from the CPR for each selected office.

Because two-stage stratification allowed the auditors to evaluate the existence of more pieces of HWCOE for a given cost compared to a simple random sample, the statistical results of the Staff's audit are likely to be more efficient. *See* Bell Aff. ¶ 12. At the same time, two-stage stratified analyses share all of the benefits of simple random samples: approximately unbiased estimates of population characteristics, consistent estimates of standard errors for such estimates, and confidence intervals that cover the population value with probability very close to the intended confidence level. *Id.* ¶ 9.

In short, the Staff correctly selected and applied standard sample design techniques. Unable to claim otherwise, Bell Atlantic and the other RBOCs advance a series of peripheral challenges. All are specious.

The Exclusion Of Very Small Offices. To ensure the most accurate estimate of the characteristics of the population on its limited budget, the Staff excluded from the samples (for some of the RBOCs) very small offices – those with fewer than 100 CPR line items – and locations that were simply too impractical to visit.[6] The RBOCs ignore these practical considerations and argue that exclusion of small offices and impractical sites could, theoretically, result in a biased estimate. These allegations are not founded on any data and, more importantly, misrepresent the most likely direction of such theoretical bias.

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[5] Otherwise, items in large offices would have been much less likely to be sampled, requiring that they receive high weights in the estimation and resulting in higher than necessary error in the point estimate. *See* Bell Aff. ¶ 14.

[6] For Bell Atlantic North/NYNEX and Bell Atlantic South, the audits even included offices containing fewer than 100 CPR line items.

Exclusion of very small offices would introduce bias only if two conditions hold: (1) the proportion of missing items in very small offices differed greatly from the proportion missing in larger offices; and (2) a substantial proportion of all items were in very small offices. Bell Aff. ¶¶ 18-19.

Bell Atlantic and the other RBOCs have failed to demonstrate that either condition holds. There is, of course, no obvious reason to suspect that very small or out-of-the-way offices would have relatively more or less missing equipment. But only the RBOCs possess the data that would reveal whether proportionately fewer items are missing in very small offices than in large offices. It is telling that the RBOCs have failed to produce any data to suggest that a greater proportion of HWCOE is missing in larger offices than in very small offices. Thus, if anything, it is reasonable to conclude that any bias generated by excluding very small central offices favors the RBOCs, *i.e.*, that the sample *underestimates* the amount of missing HWCOE.

Likewise, there is no reason to believe that small offices represent a large share of the total population of missing items. Unless a substantial proportion of all items are located in very small or hard to reach offices, any bias would be negligible. Again, the RBOCs have offered not a shred of evidence that a substantial proportion of all CPR items are located at such locations. Nor could they. As noted by Dr. Bell, the large central offices "house the lion's share of all RBOC hard-wired central office equipment," and thus the decision to exclude very small and out-of-the-way offices is entirely unobjectionable. *Id.* ¶ 13.

The Decision to Perform a "One-Way" Audit. Bell Atlantic claims that the Staff's "failure to conduct . . . a two way inspection . . . fundamentally undermines the reliability of the audit Staff's reports." Bell Atlantic at 10. In Bell Atlantic's theory, the Staff not only should have sampled the property records to see if a selected item could be located, but also should have

performed a full-blown inventory of randomly selected offices to compare against the CPRs *Id.* at 9-10. If the Staff had performed such a "two-way" audit, Bell Atlantic speculates, the Staff "may well have discovered" additional equipment that is in service but unlisted in the CPRs that could then be applied as an "offset" against the value of equipment listed in the CPRs but not actually in service. *Id.* 9-10. This argument fails for several reasons.

First, and most fundamentally, the notion that RBOCs have sizeable amounts of unrecorded HWCOE is inherently implausible. The RBOCs have ample incentive to include every piece of HWCOE in their CPR because, as discussed below, those records are used to determine Bell Atlantic's rate base, depreciation rates and other factors that can influence (and, throughout most or all of the relevant period, *have* influenced) the rates Bell Atlantic charges and the revenues it may keep (pursuant to sharing requirements). *See* Section IV.A., *infra*. It is thus extremely unlikely that Bell Atlantic would have failed to record significant amounts of equipment in its books. Thus, a two-way audit was unnecessary and would have needlessly increased the cost of the audit.

Second, and quite tellingly, Bell Atlantic again fails to offer even a scintilla of evidence that such non-recorded HWCOE exists. Bell Atlantic is in sole possession of the information that could prove or disprove the existence of such unrecorded HWCOE. Bell Atlantic's failure to offer any evidence that unrecorded HWCOE really exists warrants the inference that it does not.

Third, the Commission's rules *require* Bell Atlantic to maintain accurate CPR records so that the equipment may be readily spot-checked for proof of physical existence. 47 C.F.R. § 32.20000(f)(5). Bell Atlantic should not be heard to defend one unlawful action (*i.e.*, listing equipment that is not in service) with another (*i.e.*, failing to list equipment that is in service).

Finally, even if unlisted equipment did exist, that would in no way undermine the Staff's conclusion that substantial listed equipment is missing or the need for corrective action to remedy *that* problem. And Bell Atlantic has available a complete remedy for the separate problem of unlisted equipment (to the extent that problem exists outside of Bell Atlantic's imagination): document the unlisted equipment and list it.[7]

The Decision Not to Stratify Line Items by In-Place Cost. Bell Atlantic also asserts that the accuracy of the Staff's estimates would have been improved by "stratify[ing] the line-items by in-place cost within the selected locations." Bell Atlantic, Ex. 2 at 3 n.2 (Ernst & Young Review of the FCC Staff Reports). This strategy, however, could narrow the existing confidence intervals *only* if the distribution of cost for sampled items differed significantly from the population as a whole. Bell Aff. ¶¶ 16-17. The reality, as detailed in the Chairman's letter, is that the stratification method employed by the Staff ensured a "representative sample of high, medium, and low value items from all sizes of central offices." Letter from Chairman Kennard, FCC, to Reps. Tauzin and Dingell, Committee on Commerce, p.6 (Feb. 24, 1999) ("Chairman's Letter"). That is, the sample collected by the Staff has essentially the *same* proportion of expensive and inexpensive items as actually exist among all central offices. Chairman's Letter at attached graph (entitled *CPR Audits, Percentage of Records by Dollar Range Comparison of Population and Sample BOC Total*). Thus, the additional stratification suggested by Bell

[7] Of course, any attempt to raise rates retroactively to reflect the newly listed equipment would be unlawful. *See, e.g.*, *FPC* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 153 (1962) (a carrier "having initially filed the rates and either collected an illegal return or failed to collect a sufficient one must . . . shoulder the hazards incident to its action including not only the refund of any illegal gain but also its losses where its filed rate is found to be inadequate.")

Atlantic would have been entirely superfluous. Bell Aff. ¶ 17 ("claims . . . that the FCC Staff should have performed additional stratification merit no weight").

In addition, the Staff went one step further. To ensure that projections of total value of missing HWCOE were conservative, the Staff expressly accounted for differences in the average cost of missing items relative to the average cost of all items in the population. Thus, "if mostly low-cost items were missing, the projected missing amount would be relatively low in comparison to the projection if relatively high-cost items were missing." Chairman's Letter at 7. In fact, the "average cost per missing items was generally 80 percent of the average of all cost for all plant," *id.*, and the staff adjusted its projections to reflect this difference, an adjustment that had the effect of significantly lowering the auditors' projections.

In sum, the audit Staff used standard sampling techniques in appropriate and unremarkable ways. Bell Atlantic's speculative objections ignore both the relevant facts and the many additional steps that the Staff took to ensure that its sample would be representative of the population. Indeed, if anything, the methods employed by the Staff are overly conservative and produce underestimates of the dollar value of missing HWCOE plant – as starkly confirmed by Bell Atlantic's complete failure to support any of its conjectural objections with supporting data.

II. THE AUDIT SCORING PROCEDURES WERE REASONABLE AND, IN FACT, OVERLY GENEROUS TO THE RBOCS.

Bell Atlantic contends (at 9) that the Staff employed unreasonable audit procedures that make the Staff's findings "inherently unreliable for any purpose." The claim is baseless. The Staff's audit procedures were more than reasonable and gave Bell Atlantic the benefit of every doubt. As described in greater detail below, Bell Atlantic and the other RBOCs were given advance notice of and time to prepare for the audits. The on-site inspections were conducted in a

highly professional manner. The RBOCs actively participated in the on-site inspections, the auditors scored the sampled items in a careful and consistent manner, and the auditors remained at each central office location until the RBOCs' *own personnel* agreed that the missing items could not be found and that a exhaustive search for the sample items had been performed. The Staff then afforded the RBOCs numerous subsequent opportunities to provide persuasive evidence that the missing items had been located. Again, the Staff bent over backwards for Bell Atlantic, accepting many after-the-fact explanations and ultimately rescoring a third of the items that Bell Atlantic questioned.

Indeed, in at least three critical respects, the Staff's audit procedures were far *too* generous to Bell Atlantic and the other RBOCs. First, notwithstanding that the audit Staff remained at each central office until the RBOCs' personnel agreed that missing items could not be found, Bell Atlantic and the other RBOCs were given *four* subsequent opportunities to provide persuasive evidence that the missing equipment had been "found."

Second, when the RBOCs provided some evidence of an item's existence, but the evidence was less than fully persuasive, the Staff frequently scored the item as "unverified" rather than "not found," and thus created a large category of items for which accounting adjustments likely should have been recommended in the report, but were not.

Third, the Staff's rescoring suffered from a one-way directional bias in favor of Bell Atlantic. Although, as part of the rescoring process, the RBOCs were asked to provide explanations and documentation showing that certain items classified as "unverified" or "not found" should have been classified as "found," the RBOCs were not asked to provide documentation that would have allowed the Staff to conclude that certain items classified as

"found" or "unverified" should have been classified as "not found." As a result, *80 percent* of the Staff's rescoring involving Bell Atlantic was in Bell Atlantic's favor.

In short, Bell Atlantic's arguments concerning the alleged unreasonableness and unfairness of the Staff's audit procedures are baseless. As explained in detail in the accompanying affidavit of James K. Loebbecke, a distinguished scholar and practitioner of auditing, the staff audit procedures were well-planned, professionally executed, and fully consistent with applicable Generally Accepted Auditing Standards of the American Institute of Certified Public Accountants ("GAAS") and the Government Auditing Standards ("GAGAS"). *See* Affidavit of James K. Loebbecke ("Loebbecke Aff.") (attached hereto as Exhibit C). These conclusions reflect Mr. Loebbecke's review of the Staff workpapers and the documents made available by Bell Atlantic. In addition, Mr. Loebbecke discussed the audit procedures and findings with the senior Staff auditors in charge of the field work, and with the Staff member who oversaw the entire process. Furthermore, under Mr. Loebbecke's supervision and with his participation, AT&T internal auditors reviewed all items over $1,000 classified as "unfound" in the Staff's report for Bell Atlantic. Mr. Loebbecke and AT&T's auditors received full cooperation from the audit Staff, who responded freely and completely to their inquiries. Loebbecke Aff. ¶ 3.

A. The RBOCs Received Ample Notice And Time To Prepare For Their Audits.

The Commission's rules put Bell Atlantic on permanent notice that it is required to maintain, on an on-going basis, updated descriptions and locations of each of its in-service plant assets so that the equipment may be readily spot-checked for proof of physical existence. 47 C.F.R. § 32.2000(f)(5). Here, of course, the Commission's Staff expressly informed Bell Atlantic that such an audit would be performed, and even provided Bell Atlantic with advance

notice of the locations that would be audited. *See Audit of the Continuing Property Records of the NYNEX Telephone Operating Companies Also Known As Bell Atlantic North As of March 31, 1999*, ¶ 18 (FCC Dec. 22, 1998) ("BA-North Rpt."). Staff informed Bell Atlantic that it could line up any resources it deemed necessary to locate any items contained in the CPR, and expressly requested the assistance of Bell Atlantic personnel familiar with the equipment and offices to be audited. *Id.* Accordingly, by the time of the on-site inspections, Bell Atlantic should have been fully prepared to readily identify all of the selected CPR items.

B. The On-Site Inspections Were Conducted In A Highly Professional Manner.

Despite the cooperation of the audit Staff, Bell Atlantic elects to challenge the Staff employees' professionalism. *See* n.2, *supra*. This attack is unfounded and irresponsible.

The auditors' procedures were field-tested in advance of the actual field visits. When the auditors arrived at each central office location, the selected sample was presented to Bell Atlantic's technical Staff. BA-North Rpt. ¶ 18. Consistent with the Staff's request for assistance, three or more Bell Atlantic employees supported the Staff's verification process at each location. *Id.* The Staff and Bell Atlantic's personnel then jointly engaged in a search for the sample selections. *Id.* When the equipment was not found in the location specified in the CPR or when the CPR did not contain a specific equipment location, the Staff did not necessarily score the item as missing, but instead gave Bell Atlantic's personnel an unlimited opportunity to locate the equipment elsewhere within the office. *Id.* Indeed, "[i]n the course of this process, [the Staff was] *often* taken to other locations in the office and shown items on different frames than those listed in the CPR." *Id.* (emphasis added).

Bell Atlantic asserts that it failed to find significant amounts of equipment during the on-site inspection because "the audit Staff only allowed six hours to physically inspect each office,

or roughly ten minutes per item." Bell Atlantic at 6. In fact, each team of auditors visiting a central office was assigned to cover only 18 sample items per day. Each item in the sample should have been readily "spot-checked" if Bell Atlantic's CPR were maintained in compliance with the Commission's rules. *See* 47 C.F.R. § 32.2000(e). Moreover, the Staff remained at each central office location until *Bell Atlantic's own personnel* agreed that the missing items could not be found and that a complete search for the sample items had been performed. Loebbecke Aff. ¶ 7.

The results of the inspection then were scored to indicate whether equipment was found as listed in the CPR, was found in a different location or quantity than listed in the CPR, was not found after an exhaustive search by either the Staff or Bell Atlantic personnel, or could not be verified as found or not found. *Id.* The standards for classifying an item as "not found" were stringent – items were considered not found only when, after an exhaustive search by both the auditors and Bell Atlantic's personnel, "the sampled equipment could not be located *anywhere* in the central office." BA-North Rpt. ¶ 18 (emphasis added).

By contrast, the standards for classifying an item as "unverified" were lenient: if the auditor had some reason to believe, but was uncertain, that an item had been located, the auditor categorized the equipment as "unverified" instead of "not found." BA-North Rpt., App. C at 1-2 (Problems Encountered In The Verification Process). The auditors thereby gave Bell Atlantic the benefit of the doubt during the physical inspection by classifying a large number of items that could not be verified with certainty as "unverified" rather than "not found." *Id.* Overall, the auditors scored 17 percent of the sampled items as "unverifiable," and only 8.5 percent as "not found."

Because a significant fraction of the "unverifiable" items are likely to be missing, and should have been scored as "not found," the tallies of "not found" items in the audit reports imply a significant underestimate of the total dollar amount of missing equipment. The auditors' dollar estimates were based solely on the number of items actually scored as "not found"; "unverifiable" items were omitted from the calculations. BA-North Rpt. ¶¶ 22-23.

As Mr. Loebbecke explains in his attached affidavit, the on-site audit work conducted by the Staff was well-planned, supervised, and reviewed. All on-site auditors were provided with inventory forms that included space to specify whether the units of equipment were found and whether the CPR description and location were correct. In addition, the inventory forms had space for notations concerning unusual or important observations with respect to each record. Not only was the work paper documentation clear, concise, consistent, and complete, the audit supervisor reviewed the inventory forms upon completion of the on-site visit to ensure the accuracy and consistency of the findings. Accordingly, there is no reasonable basis for disparaging the reliability of the audit Staff's work papers or the initial scorings.

C. The Staff Gave Bell Atlantic Numerous Opportunities For Rescoring.

Bell Atlantic received multiple further opportunities after the on-site visits to document the location of items tentatively scored as "not found." On June 27, July 8, and October 8, 1997, the Staff provided preliminary results to Bell Atlantic, and specifically asked it to provide whatever additional explanations and documentation it wanted the Staff to consider in potentially rescoring items initially scored as "not found." BA-North Rpt. ¶ 20 n.30. On July 20, 1998, the Staff completed its draft report, submitted its findings to Bell Atlantic, and gave it yet another opportunity to submit written responses and any other information Bell Atlantic deemed relevant. *Id.* ¶ 20. Bell Atlantic filed its response on August 19. The auditors revised their