

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554

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

**MCI WORLDCOM REPLY COMMENTS**

MCI WorldCom, Inc. (MCI WorldCom) hereby submits its reply to comments on the Further Notice of Proposed Rulemaking (Notice) in the above-captioned proceeding.

**I. Introduction and Summary**

Only four months ago, in the Depreciation Order, the Commission determined that the depreciation rates and factors used by the ILECs for financial reporting are not appropriate for regulatory purposes.<sup>1</sup> Neither the Notice nor the ILEC comments provide any reasoned basis for the Commission to now change course and allow all price cap ILECs

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<sup>1</sup>1998 Biennial Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers, Report and Order and Memorandum Opinion and Order, CC Docket No. 98-137; ASD 98-91, released December 30, 1999 at ¶ 17, 48 (Depreciation Order).

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to use financial depreciation rates for regulatory accounting.

In their comments, the ILECs cite the possible adoption of the CALLS plan as justification for their depreciation relief proposal.<sup>2</sup> However, as MCI WorldCom showed in its initial comments, the CALLS plan does not change the fact that the ILECs remain dominant carriers, or change the fact that the ILECs will still be free to claim a low-end adjustment at any time, or change the fact that many states rely on the Commission's depreciation expertise in setting interconnection and UNE rates.<sup>3</sup>

MCI WorldCom also showed that adverse impacts on customers and competition cannot be mitigated by applying, on an industry-wide basis, conditions or safeguards such as those outlined in the Depreciation Order's waiver discussion. Regardless of the conditions or safeguards imposed, allowing the ILECs to use financial depreciation rates and factors for regulatory accounting would distort the ILECs' reported earnings, would allow the ILECs to inappropriately trigger low-end adjustments, and would bolster the ILECs' arguments that their financial depreciation factors should be used in universal service and UNE/interconnection cost models.

Even if industry-wide application of the Depreciation Order's waiver conditions were sufficient to protect consumers and competitors, which it is not, the Commission would have to terminate this rulemaking for the simple reason that the ILECs refuse to comply with these conditions. Now that the ILECs have had the opportunity to explain in more detail the proposal sketched out in their March 3, 2000 ex parte, it is clear that

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<sup>2</sup>See, e.g., SBC Comments at 4; GTE Comments at 8.

<sup>3</sup>MCI WorldCom Comments at 4-5.

their proposal falls well short of providing the same protections as the Depreciation Order's waiver conditions.

**II. The ILECs' Proposal Does Not Provide the Same Protections as the Depreciation Order's Waiver Conditions**

In the Depreciation Order, the Commission stated that it would consider alternatives to the Depreciation Order's four waiver conditions, but only if the alternative proposal provided the same protections against adverse impacts to consumers and competition.<sup>4</sup> The ILEC comments show that their proposal does not satisfy this requirement.

**A. The ILECs' Proposal for an Above-the-Line Amortization Does Not Provide the Same Protections as the First and Third Waiver Conditions**

All non-ILEC commenters agree that the ILECs' proposal for a five-year above-the-line amortization (coupled with the ILECs' "commitment" not to seek recovery of the amortization expense through a low-end adjustment, exogenous adjustment, or above-cap filing) does not provide the same protection as the Depreciation Order's first and third waiver conditions. For example, Ad Hoc states that "the protections volunteered by the ILECs are not nearly enough to afford consumers the same level of protection that is achieved under the Commission's requirement that the write-off be taken below-the-line."<sup>5</sup>

The ILECs' claim that their "commitment" not to seek recovery provides the same degree of protection as a below-the-line adjustment is undermined by the ILECs' own comments. First, the fact that the ILECs' proposal for a five-year-above-the line amortization is predicated on a reserve deficiency claim is inconsistent with the

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<sup>4</sup>Depreciation Order at ¶ 25.

<sup>5</sup>Ad Hoc Comments at 7.

Commission's requirement that "carriers would have to voluntarily forego their opportunity to recover such potential claims before [the Commission] could find that unrestricted changes in depreciation practices were consistent with the public interest."<sup>6</sup>

Furthermore, the ILEC comments reveal that the ILECs' much touted "commitment" not to seek recovery of the amortization expense through a low-end adjustment, exogenous adjustment, or above-cap filing falls well short of satisfying the Commission's third waiver condition. In particular, the CALLS ILECs now admit that they will not honor their commitment, and will seek recovery of the amortization expense, if the Commission does not adopt the CALLS plan in its current form. BellSouth, for example, states that "if the CALLS Plan were not approved by the Commission, BellSouth, as other ILECs, would not be willing to forego the recovery of the amortization amount . . . ."<sup>7</sup>

Some ILECs, such as U S West, refuse to make even the limited commitment made by the CALLS ILECs. U S West states that it "does not care to join this act of self-sacrifice,"<sup>8</sup> and goes on to say that "[e]ven if U S West supported the CALLS price cap proposal, it would not voluntarily accept the conditions for elimination of depreciation regulation which were articulated in the CALLS Coalition's March 3, 2000 Ex Parte."<sup>9</sup>

Finally, all of the ILECs refuse to make any commitment with respect to recovery of alleged reserve deficiencies through intrastate rates. Whereas the Commission suggested in

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<sup>6</sup>Depreciation Order at ¶ 27 n.85.

<sup>7</sup>BellSouth Comments at 4 n.4.

<sup>8</sup>U S West Comments at 3.

<sup>9</sup>Id., n.8.

the Notice that it “believe[d] the ILECs intend to commit not to seek recovery, at the state level, of any portion of the amortization,”<sup>10</sup> the ILEC comments show the Commission’s belief to have been misplaced. All of the ILECs assert that the Commission has no authority to require any commitment with respect to intrastate recovery as a condition for depreciation relief. And the ILECs do not even make voluntary commitments with respect to intrastate recovery. U S West, for example, states that it “fully intends to seek recovery of all expenses lawfully incurred in the provision of intrastate service, including depreciation expense and any applicable depreciation reserve deficiency.”<sup>11</sup>

There is no basis on which the Commission could allow an above-the-line amortization and recovery opportunity that is predicated on the existence of an imaginary reserve deficiency. Only four months ago, in the Depreciation Order, the Commission stated that it “[did] not agree that the incumbent LECs’ plant is underdepreciated.”<sup>12</sup> The Commission observed that the ILECs’ depreciation reserves are at 51 percent, an all-time high, and have increased for each of the past five years.<sup>13</sup>

The Commission made clear that the adjustment of reserve levels contemplated by the Depreciation Order is not related to a reserve deficiency or tantamount to a finding that the ILECs’ financial depreciation rates are “correct.” Rather, the adjustment of reserve levels is a necessary safeguard to prevent ILECs that are using financial depreciation rates

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<sup>10</sup>Notice at ¶ 10, n.25.

<sup>11</sup>U S West Comments at 6-7.

<sup>12</sup>Depreciation Order at ¶ 65.

<sup>13</sup>Depreciation Order at ¶ 16.

from inflating their revenue requirements. As the Commission explained, the one-time below-the-line write-off is important because it provides “assurance that carriers do not engage in a practice that would disadvantage consumers and competition by using high financial depreciation rates with high regulatory net book costs . . . .”<sup>14</sup> Not only would the ILECs’ claim of an imaginary reserve deficiency stand the Depreciation Order’s reasoning on its head, but the five-year amortization would, as MCI WorldCom showed in its initial comments, allow the ILECs to inflate their revenue requirements by using high financial depreciation rates with high regulatory net book costs.<sup>15</sup>

Because (1) the ILECs continue to assert reserve deficiency claims; (2) the ILECs’ “commitment” provides no assurance that the ILECs will not seek recovery; and (3) the five-year amortization will inflate ILEC revenue requirements, the ILECs’ proposal falls well short of providing equivalent protections to those offered by the Depreciation Order’s first and third waiver conditions. The Commission should terminate this rulemaking because the ILECs refuse to comply with these conditions.

**B. The ILECs Refuse to Comply with the Fourth Waiver Condition**

Not only do the ILECs refuse to comply with the first and third waiver conditions, but they refuse to comply with the fourth waiver condition as well. They refuse, in particular, to submit information concerning forecast additions and retirements for major network accounts and replacement plans for digital central offices.<sup>16</sup> The Commission

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<sup>14</sup>Depreciation Order at ¶ 26.

<sup>15</sup>MCI WorldCom Comments at 10-11.

<sup>16</sup>See, e.g., GTE Comments at 13-14.

requires this information in order to maintain realistic ranges of depreciable life and salvage factors for use in universal service and UNE/interconnection cost models.<sup>17</sup>

The ILECs refuse to provide this information because, they argue, the Commission's depreciation parameters should no longer be used in cost models. In essence, the ILECs are arguing that a Commission decision that permits them to use financial depreciation rates for regulatory accounting would be tantamount to a finding that the ILECs' financial depreciation rates and factors are appropriate and should be used for all purposes, including cost models. BellSouth and SBC, for example, assert that "[b]y modifying its rules to permit price cap LECs to set their own depreciation rates, the Commission would authorize the use of the proposed economic depreciation rates for all their reporting to the Commission," including "any future cost estimates or studies."<sup>18</sup> Similarly, Cincinnati Bell argues that "[f]or the Commission to acknowledge the use of the same depreciation treatment for regulatory and financial accounting, yet continue to set ranges for USF and interconnection/UNE purposes, is not logical."<sup>19</sup>

The ILEC proposal seeks to stand the Depreciation Order's reasoning on its head. When the Commission adopted the waiver framework in the Depreciation Order, it made clear that a waiver allowing a price cap ILEC to use financial depreciation rates for bookkeeping purposes should not be read as a finding that the ILEC's financial depreciation

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<sup>17</sup>Depreciation Order at ¶ 31.

<sup>18</sup>BellSouth Comments at 10.

<sup>19</sup>Cincinnati Bell Comments at 3.

rates are appropriate.<sup>20</sup> Indeed, the purpose of the fourth waiver condition is to “address areas where reliance on the carriers’ financial depreciation rates may be inconsistent with other regulatory policy goals.”<sup>21</sup>

The ILECs’ refusal to comply with the fourth waiver condition compels the Commission to terminate this rulemaking without granting the relief sought by the ILECs. Not only have the ILECs failed to show that their proposal protects consumers and competitors, but the ILECs’ attempt to stand the Depreciation Order’s reasoning on its head underscores the risks associated with deregulating ILEC depreciation practices. The ILEC comments in this proceeding show that, by allowing the ILECs to use financial depreciation rates for regulatory accounting, the Commission would bolster the ILECs’ argument that their financial depreciation factors should be used in cost models as well. NARUC agrees with this assessment, warning that there “will certainly be more pressure for the FCC and states to use the financial depreciation rates as inputs to the proxy models.”<sup>22</sup>

### **III. The CPR Audits Are Not Rendered Moot**

All non-ILEC commenters agree that the CPR audits would not be rendered moot by any change in the ILECs’ depreciation practices. As GSA points out, the CPR audit findings address the level of the ILECs’ gross plant, not the level of their depreciation reserve.<sup>23</sup> Regardless of any changes made to the level of the ILECs’ depreciation reserve,

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<sup>20</sup>Depreciation Order at ¶¶ 17-19, 61.

<sup>21</sup>Depreciation Order at ¶ 31.

<sup>22</sup>NARUC Comments at 7.

<sup>23</sup>GSA Comments at 10.

overstated gross plant balances would still result in overstated depreciation expense.

The ILECs do not even attempt to explain why a change in the level of their depreciation reserve should have any bearing on an issue that deals with the level of their gross plant. Instead, they assert that the CPR audits would be rendered moot because adoption of the CALLS plan would make book costs irrelevant. This claim is without merit. First, as AT&T points out, the CALLS plan does nothing to address past overcharges that may have resulted from overstatement of the ILECs' plant balances. Second, the CALLS plan takes as its starting point the current level of price caps, which have been inflated by the overstated ILEC plant balances. Third, book costs would continue to affect rate levels even under the CALLS plan, because the CALLS plan retains the low-end adjustment mechanism. Finally, even if the CALLS plan is adopted, the Commission would still have an obligation to monitor ILEC earnings in order to ensure just and reasonable rates.

The ILECs also ignore the fact that adoption of the CALLS plan would only affect interstate rates. The overstated plant balances resulting from the ILECs' deficient CPR practices have inflated intrastate rates as well, particularly in those states that have continued to use rate of return regulation. All of the state commissions commenting in this docket agree that the CPR audit proceeding should not be terminated as moot.<sup>24</sup>

Finally, the adoption of the CALLS plan would do nothing to correct the deficient ILEC CPR practices uncovered by the auditors. Several commenters agree that the

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<sup>24</sup>Florida Comments at 9-10; Wisconsin Comments at 5-6; Indiana Comments at 5-6; NARUC Comments at 10-12.

Commission cannot terminate the CPR audit proceeding without first acting on the auditors' recommendations that the ILECs engage independent firms to conduct complete inventories of their CPRs and engage independent auditors to evaluate the ILECs' CPR practices, procedures, and controls.<sup>25</sup>

#### **IV. Conclusion**

The Commission should terminate this rulemaking because the ILECs refuse to comply with the waiver conditions discussed in the Depreciation Order.

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<sup>25</sup>See, e.g., GSA Comments at 10.

## CERTIFICATE OF SERVICE

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