Rate of Return Regulation:
Problems That Can No Longer Be Ignored

ATTACHMENT A

to

Western Wireless Corporation's

**Petition For Rulemaking To
Eliminate Rate-Of-Return Regulation
Of Incumbent Local Exchange Carriers**

October 30, 2003

Rate of Return Regulation:
Problems That Can No Longer Be Ignored

Rate of Return Regulation: A Failed Model of Economic Regulation

Western Wireless Corporation ("Western Wireless") addresses the theoretical and practical problems that result from using an embedded cost/rate of return methodology to determine universal service funding for smaller incumbent local exchange carriers ("ILECs") in a separate paper, "Rate of Return Regulation: A Failed Model of Economic Regulation," released on June 3, 2003.[1] Western Wireless showed that carriers have both the incentive and ability to manipulate their embedded cost study results to maximize their universal service fund ("USF") and/or interstate access revenue and documented instances in which the Federal Communications Commission ("FCC") has found that carriers have done so. Western Wireless recommended that rate of return regulation for smaller ILECs be replaced by a system in which USF payments to all ILECs are based on forward looking economic costs ("FLEC"). Until such time as an appropriate FLEC model can be developed for smaller ILECs, Western also recommended that the FCC establish a stringent and comprehensive audit program over ILEC embedded cost studies to ensure the integrity of the high cost fund mechanisms.

In this Paper, Western Wireless further documents instances in which ILECs have manipulated their embedded cost studies to maximize their USF and/or access revenue. This time, Western Wireless focused its review on state commission proceedings in which large or small ILEC embedded cost studies were thoroughly scrutinized. State commissions typically conduct more comprehensive audits or reviews of carriers' cost studies than does NECA or the Commission, which, in itself, is a problem and raises the issue of lack of federal oversight of ILEC cost studies. It is highly likely that, if conducted by NECA or the FCC, thorough audits of ILECs' USF and access cost studies would reveal problems similar to those identified by the states herein (the problems with the ILECs' federal cost studies would likely be of even greater magnitude given the historic lack of oversight).

The cost studies reviewed for this Paper were submitted in different types of proceedings: rate cases, earnings investigations, state universal fund audits, and earnings sharing calculations under alternative regulatory mechanisms. The lack of oversight of ILEC cost studies is also a problem at the state level because detailed reviews of carrier cost submissions have become less common in the last few years -- most states no longer regulate the former Bell Operating Companies ("BOCs") on a rate of return basis and many states either no longer or do not actively regulate the local rates of smaller ILECs and/ or cooperatives.

The results of Western Wireless' review of state commission proceedings involving ILEC cost studies are striking. In virtually all instances, significant problems with the carriers' cost submissions were identified that resulted in disallowances of specific cost items and/or a settlement with the carrier receiving significantly less than originally requested. The abuses uncovered included misstated affiliate transactions, failure to fully and accurately identify and allocate nonregulated costs, inclusion of costs that were not related to the provision of regulated services, and accounting misclassifications.

Kansas Case Study

In 1998, the Kansas Corporation Commission ("KCC") began a series of audits and general rate investigations of ILECs that received Kansas Universal Fund Support ("KUSF") to ensure that the level of support received by each carrier was based on its costs and that its rates were just and reasonable. Many of these proceedings resulted in stipulated settlements with no detailed findings and conclusions, but simply a settlement that required the company to reduce its draw from the KUSF to eliminate excess intrastate earnings.

JBN Telephone Company: The telephone company claimed a revenue deficiency of $572,917, but after KCC scrutiny of its costs, JBN entered into a settlement agreement that required it to reduce intrastate revenues by $690,000 annually by reducing its draw form the KUSF.[2]

Wilson Telephone Company: The telephone company claimed a revenue deficiency of $142,459, but reached a settlement with the KCC that required it to reduce intrastate revenues by $148,000.[3]

Craw-Kan Telephone Cooperative: The telephone company claimed a revenue deficiency of approximately $300,000, but agreed to reduce its intrastate revenues by $500,000 in a settlement with the KCC.[4]

Bluestem and Sunflower Telephone Companies: Bluestem and Sunflower are subsidiaries of Fairpoint Communications, a mid-sized holding company.[5] One of the principal areas of contention was the management services agreement between the telephone companies and the holding company/service corporation. The management services agreement governed the allocation of costs charged to the telephone companies for corporate and management services. The findings of the KCC are revealing of the types of issues and problems that can be uncovered by a careful investigation of telephone company costs, including:[6]

- Financial advisory fees paid to Fairpoint's investor/owners for advice on equity financing and strategic planning of $1 million were allocated to the telephone companies. These were deemed not related to the provision of regulated services.

- The cost of stock based compensation ($12.3 million), essentially stock dividends, was allocated to the telephone companies. The staff found that "Rate Base rate of return regulation does not recognize dividends as part of the revenue requirement determination; therefore, the inclusion of this charge effectively provides a return to the corporate parent and a return or profit above the authorized return, to the investor."[7]

- Some nonregulated subsidiaries (e.g., Fairpoint Solutions) appeared to receive no allocation of corporate costs and some of the proposed allocation factors effectively resulted in no costs being allocated to many nonregulated subsidiaries. Some subsidiaries had zero or negative cost allocations.

- Historically, management fee allocations were based on revenues, which do not necessarily reflect cost causation.

- It was left to the General Manager's discretion to determine which accounts should be charged the management fees, potentially compromising the integrity of the companies' accounts.

The KSS staff's recommendation was that only $10.6 million of Fairpoint's corporate costs should be allocated to its operating companies, compared to the $34.2 million Fairpoint had allocated for its 2000 test year. Under the settlement agreement reached with Bluestem and Sunflower, the telephone companies were required to reduce their draw from the KUSF to zero.

<u>Southern Kansas Telephone Company</u>: In its review of Southern Kansas' cost studies, the KCC uncovered other ingenious attempts a misallocation of costs, including:[8]

- Southern Kansas claimed deferred income tax asset included the effects of tax timing differences related to nonregulated expenses.

- Southern Kansas claimed depreciation expense on plant that had been fully depreciated.

- Southern Kansas failed to reflect a known and measurable increase in federal USF for the period when KUSF would be paid and rates would be in effect.

- Payments to a consulting group that focuses on family relationships and the dynamics of families working together had not been shown to benefit regulated ratepayers.

In the end, the KCC found that Southern Kansas had over earnings in excess of $2,828,214.

Rural Telephone Company: The KCC found the following transgressions on the part of Rural Telephone Company:[9]

- Claimed more property tax expense than it had actually paid during the test year.

- Calculated its depreciation expense on its largest outside plant accounts using depreciation rates in excess of those permitted by the KCC.

- Included lobbying and corporate image advertising expenses, costs that benefit the company, not the regulated ratepayer.

As a result of these, and other adjustments, the KCC found that Rural had excess intrastate revenues of $801,533.

California Case Study

The California Public Utilities Commission's (CPUC) Office of Ratepayer Advocates (ORA) conducted an extensive audit of the affiliate and nonregulated transactions of Roseville Telephone Company ("RTC") and uncovered the following improper allocations of costs:[10]

- RTC's CEO, CFO and their staffs had allocated only 8 out of 31,000 hours to affiliate and nonregulated operations.
- RTC's VP of marketing had done some work for Roseville Cable, but the costs were not properly assigned to Roseville Cable.
- RTC failed to assign any accounting, budget and finance development costs and the revenue accounting manager's time to Roseville Long Distance.
- RTC had allocated its information services costs based on out of date and incorrectly developed end user service order, payment and collection factors that underallocated RTC's computer infrastructure costs to affiliates and unregulated operations.
- The cost of a valuation study related to the transfer of RTC's wireless interests to an unregulated affiliate were charged to RTC.
- RTC failed to bill Roseville Cable for regulatory costs incurred for Roseville Cable.
- Alarm Monitoring costs were inappropriately booked in RTC's regulated accounts.
- Employee health insurance costs for an unregulated affiliate were paid by RTC.
- RTC had booked the costs of institutional and goodwill advertising in its regulated accounts, in direct contravention of CPUC policies.
- RTC failed to bill a substantial portion of the costs to establish its long distance affiliate to that affiliate.
- RTC charged its wireless affiliate a market rate for office space rather than a fully distributed cost based rate as required by the CPUC.

- RTC used on outdated factor to allocate land and building costs to its nonregulated activities which understated this allocation and failed to allocate any land and building costs to its affiliates.

- The factor RTC used to allocate residual general and administrative costs to affiliates was inconsistent with the FCC's Part 64 Rules and understated the allocation to affiliates.

- RTC expensed its entire software development costs in 1999, contrary to GAAP (SOP 98-1), even thought the software would be used in future years.

These improper allocation of costs resulted in over earnings by RTC: in 1997, RTC's rate of return was 10.77% instead of the allowable 9.12%; in 1998, RTC's rate of return was 11.86% instead of the allowable 10.14%; and in 1999, RTC's rate of return was 14.60% instead of the allowable 10.55%.

Washington Case Study

In 1995, U S WEST Communications (now Qwest) requested a general rate increase of over $204 million based on traditional rate of return regulation from the Washington Utilities and Transportation Commission ("WUTC"). In 1996, the WUTC rejected the proposed rate increase and instead ordered Qwest to reduce its rates by $91.5 million.[11] Among the relevant findings and disallowances made by the WUTC were:

- Costs related to a major restructuring program were disallowed because the benefits from the program had not yet been realized and current costs far exceeded benefits.

- Corporate image advertising costs were disallowed.

- The company's proposed jurisdictional separation factors allocated excessive costs to the intrastate jurisdiction compared to historical trends.

- WUTC disallowed Qwest's bonuses, Team Awards and Merit Awards because the standards used did not benefit ratepayers, especially in light of the company's poor service quality record.

- The WUTC rejected Qwest's attempt to use depreciation rates that the WUTC had recently rejected.

- Qwest purchased procurement and warehouse services from an affiliate at prices based on the affiliate's costs plus a return. These prices, however, exceeded the market prices for such services.

- The WUTC disallowed certain R&D costs paid to affiliates, as their potential benefits to ratepayers could not be determined.

- Certain payments to Qwest's corporate parent were disallowed because they were duplicative of functions the company performed itself, were not directly related to regulated operations, or were for corporate image advertising.

- The company failed to reflect the deferred tax effects of its sale of several exchanges, sharing of excess earnings, and flow through of the tax consequences of its pension asset, resulting in a significant overstatement of its rate base.

- The company failed to synchronize the interest expense used in its federal income tax calculation with the WUTC's allowed weighted cost of debt.

Oregon Case Study

U S WEST Communications (now "Qwest") was required to submit a general rate filing to the Oregon Public Utility Commission ("OPUC") prior to expiration of its Alternative Form of Regulation ("AFOR") at the end of 1996. In its revenue requirement filing, Qwest requested an increase of $28 million. The OPUC made the following findings:[12]

- The OPUC disallowed a negative (debit) balance in Qwest's cross bar and step-by-step depreciation reserve accounts because the equipment had been retired in 1989 and a portion of the amount was due to equipment that had been used in Washington.

- Qwest failed to reflect the reduction in expenses it experienced as a result of its sale of several exchanges.

- The OPUC disallowed bonuses paid to Qwest management and executives because these bonuses were paid for achieving corporate financial goals, which benefited shareholders, not ratepayers.

- The OPUC disallowed a significant portion of Qwest's accrual for accident and damage claims as the company had accrued amounts in excess of actual payments during the test period.

- The direct costs of Qwest's reengineering program as well as extraordinary expenses incurred by the company due to the disruption the program caused in the company's operations were disallowed, as the benefits of this program had not been realized.

Overall, the OPUC ordered Qwest to reduce its revenue requirement by $97.2 million.

Idaho Case Study

In 1996, U S WEST Communications (now ("Qwest") requested a general rate increase for its price-regulated services of $38 million, a 58% increase (Qwest's request was later reduced to $15 million) from the Idaho Public Utilities Commission ("IPUC"). The IPUC staff initially recommended a rate decrease of $32 million, later adjusted the decrease to approximately $20 million (many issues were settled, typically by splitting the difference between the company and staff positions).[13]

Based upon its review of Qwest's cost study, the IPUC made the following observations:

- The company's claim for payments to affiliates was reduced because many of the payments were not for services related to the provision of basic local service.

- Telephone concession and employee recognition expenses were reduced.

- A portion of corporate image advertising was disallowed.

- The company should have amortized its restructurings/reengineering expenses over 15 years rather than in one year because the benefits of the restructuring and reductions would be realized in the future.

- Qwest agreed to forgo its proposed claim for recovery of its depreciation reserve deficiency.

- Costs related to nonregulated services, such as alarm monitoring, CPE and inmate services, were removed from the company's revenue requirement.

- A substantial portion of Qwest's software capital leases were not related to the provision of basic local service but rather supported CLASS and access services.

- The IPUC required Qwest to remove 20% of its fiber investment from its rate base because a substantial portion of its fiber was unlit.

- Because a staff audit revealed that that a portion of its central office equipment was missing (i.e., no longer in service), the company was required to reduce its central office investment.

In the end, the IPUC required the company to reduce its rates by $327,000.

Vermont Case Study

In 1999, the Vermont Public Service Board ("Board") initiated a proceeding to develop the "Vermont Incentive Regulation Plan" for Bell Atlantic-Vermont (now "Verizon"). The plan required Verizon to freeze rates for its regulated services over the five-year life of the plan while providing Verizon with pricing flexibility for competitive and new services. Prior to implementing the plan, the Board investigated Verizon's cost of service/revenue requirement to ensure that the company's existing rates were just and reasonable. In its Order adopting the plan[14], the Board made a number of adjustments to Verizon's cost of service, such as:

- The Board rejected Verizon's proposed reduction in the amortization period from 20 years (the period the Board had previously approved at Verizon's request) to 5 years, as the company had presented no compelling reason for the change.
- The company was not permitted to recover its nonrecurring OSS costs related to providing unbundled network elements as these costs had already been recovered in wholesale and retail rates.
- The Board rejected Verizon's proposed amortization of its restructuring costs and substituted an amount that also reflected Verizon's incremental savings from its restructuring program.
- Because Verizon attempted to recover a portion of its net costs of its merger with NYNEX, even though it had previously claimed that the merger would result in substantial savings, the Board rejected Verizon's cost estimate and substituted its own which reflected merger related savings.
- The Board rejected Verizon's proposed amortization of merger related severance costs, as it was a one time, nonrecurring event.
- The Board reduced Verizon's R&D costs to reflect the effect of its recent sale of Bellcore.
- Because the company could not explain why the expenses shown in its financial reports were higher than its claimed rate case expenses, it was required to reduce its cost of service by the difference.

- The company was not allowed to recover its costs of LNP implementation because the FCC had found these were interstate costs and had developed a mechanism for their recovery.

Based upon these transgressions, the Board found that Verizon was over-earning by approximately $23 million annually.

The Vermont Board has also conducted rate investigations of a number of smaller ILECs in recent years. While these proceeding have generally been resolved by stipulated settlements with no specific findings regarding the companies' revenue requirement filings, in all cases the settlement amount is less than the amount claimed by the company, in some cases considerably. For example, Northland Telephone Company of Vermont requested a revenue requirement of $3,836,681 but settled for $3,242,617, a reduction of 15.5%.[15] Similarly, Ludlow, Northfield and Perkinsville Telephone Companies requested a revenue requirement of $4,364,332 while the stipulated amount was $3,827,546, a reduction of 13.3%.[16] And, Waitsfield-Fayston Telephone Company requested $13,122,618 but settled for $11,462,618, a reduction of 12.6%.[17]

Conclusion

This brief review of state proceedings in which ILEC revenue requirement/cost of service filings were closely scrutinized strongly suggests that similar oversight of the cost support submitted by rate of return ILECs' for USF purposes would result in significant reductions in the size of the high cost fund. Rate of return carriers have strong incentives to recover as much of their costs from regulated services as possible and, not surprisingly, they act on these incentives, especially in the absence of a strong oversight function. And, with the proliferation of unregulated affiliates and services in recent years, the opportunities for cost shifting and cross-subsidization have increased.

Clearly, under rate of return regulation, ILECs have the incentive to improperly allocate their costs in a manner that allows them to realize a financial windfall. The most common improper accounting practices include the following:

- Excessive charges from unregulated affiliates to regulated operations.
- Under or no allocation of unregulated costs to unregulated operations.
- Retired plant treated as still in service.
- Depreciation and amortization costs in excess of allowed amounts.
- Understated charges from the regulated operation to unregulated affiliates.
- Accounting misclassifications.
- Overstated expenses and investment.

These improper accounting practices were uncovered in anticipated state commission proceedings that the carriers knew would result in close scrutiny of these cost studies. Because ILEC cost studies submitted to NECA and the FCC are not subject to much scrutiny, the incentive and ability for carriers to overstate their costs is significantly higher than in the state commission cost study proceedings. These problems could be avoided by adopting a FLEC methodology as the basis for high cost funding.

Endnotes

[1] *See Rate of Return Regulation: A Failed Model for Economic Regulation* (Attachment B to this Petition). That document was also submitted as Attachment C to Reply Comments of Western Wireless Corporation, In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, June 3, 2003.
[2] In the Matter of an Audit and General Rate Investigation of JBN Telephone Company, Inc., Docket No. 02-JBNT-846-AUD, Joint Motion to Approve Stipulation and Agreement, Nov. 2002.
[3] In the Matter of an Audit and General Rate Investigation of Wilson Telephone Company, Inc Docket No. 02-WLST-210-AUD, Joint Motion to Approve Stipulation and Agreement, July 2002.

[4] In the Matter of an Audit and General Rate Investigation of Craw-Kan Telephone Cooperative, Inc., Docket No. 01-CRKT-713-AUD, Joint Motion to Approve Stipulation and Agreement, October 2001
[4] In the Matter of an Audit and General Rate Investigation of Bluestem Telephone Company, Inc., Docket No. 01-SSTT-878-AUD, In the Matter of an Audit and General Rate Investigation of Sunflower Telephone Company, Inc., Docket No. 01-SFLT-879-AUD, Joint Motion to Approve Stipulation and Agreement, April 2003.

[6] Id., Staff's Report and Recommendation on the Management Services Agreement Filed September 27, 2002, October 2002.
[7] Id., p. 15.
[8] In the Matter of an Audit and General Rate Investigation of Southern Kansas Telephone Company, Inc., Docket No. 01-SNKT-544-AUD, Non-Confidential Order Setting Revenue Requirements, September 2001.

[9] In the Matter of an Audit and General Rate Investigation of Rural Telephone Company, Inc., Docket No. 01-RLLT-083-AUD, Order Setting Revenue Requirements, June 2001.
[10] In the Matter of the Application of Roseville Telephone Company (U 1015 C) to Review Its New Regulatory Framework, Application 99-03-025, Decision, June 28, 2001.
[11] Washington Utilities and Transportation Commission v. U S WEST Communications, Inc., Docket No.UT-950200, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling, April 1996.
[12] Re. Application of U S WEST Communications for an Increase in Revenues, Docket No. UT 125, Order No. 97-171, May 19, 1997.
[13] Re. The Application of U S WEST Communications for Authority to Increase its Rates and Charges for Regulated Title 61 Services, Case No.USW-S-96-5, Order No. 27100, August 27, 1997.
[14] Investigation into an Alternative Regulation Plan for new England Telephone and Telegraph d/b/a Bell Atlantic-Vermont, Docket No. 6167, Order, March 24, 2000.
[15] Investigation into the existing rates of STE/NE Acquisition Corp d/b/a Northland Telephone Company of Vermont, Docket No. 6474, Order, October 3,2001.
[16] Investigation into the existing rates of Ludlow Telephone Company, Northfield Telephone Company, and Perkinsville Telephone Company, Docket No. 6576, Order, April 11,2002.
[17] Investigation into the existing rates of Waitsfield-Fayston Telephone Company, Docket No. 6417, Order, January 9,2001.