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- RTC used an outdated factor to allocate land and building costs to its nonregulated activities which understated this allocation and failed to allocate any land and building costs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 though 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 findings¹²

- 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 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 plan¹⁴, 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 HFC's in recent years. While these proceedings 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-JBN1-846-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

⁵ 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-SFTT-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-RLT-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/NF 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

Rate of Return Regulation:
A Failed Model for Economic Regulation

ATTACHMENT B

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: *A Failed Model for Economic Regulation*

Introduction

Rate of return regulation, in one form or another, has been used since the late nineteenth century to set and constrain the earnings and price levels for economically regulated companies.¹ In the last fifteen years, however, it has been widely supplanted by alternative mechanisms to set prices and control earnings of telecommunications carriers in the United States and many foreign countries. In particular, the FCC has adopted alternative forms of regulation to, in chronological order, set interexchange carrier rates, interstate access rates, and unbundled network element and transport and termination charges, and establish the high cost support payments for those regulated carriers serving the vast majority of customers in the U.S. State commissions have also abandoned rate of return regulation for the most part, with only six commissions continuing to use rate of return regulation for the RBOCs in their states.² At the FCC, the single exception to this wholesale abandonment of rate of return regulation has been its continued application to the development of the interstate access rates charged and the universal fund payments received by smaller incumbent LECs.

This paper addresses the infirmities, both theoretical and practical, of rate of return regulation that have been identified by the FCC in the past and suggests that the time has come to commence a serious and concerted effort to develop a forward looking economic cost (FLEC) model to determine the universal service receipts for rural ILECs and, potentially, their interstate access rates. If, however, as been found in the past, this is deemed impracticable, the Commission should, at a minimum, establish comprehensive auditing standards and requirements over ILEC reporting of USF costs to ensure their accuracy and compliance with the applicable Part 32, 36, 54, 64 and 65 Rules. Given the magnitude of the "unexplained" growth in payments to the ILECs³, the potential and incentives for companies to overstate their USF eligible costs, and documented abuses of the rate of return process in the past, additional scrutiny of carriers' USF reporting is essential to ensure the integrity of the high cost USF mechanisms.

The FCC's Rejection of Rate of Return Regulation

For over fifteen years, the FCC has been evaluating the efficacy of rate of return regulation as a tool to achieve its regulatory objectives and has found it wanting in virtually all instances. While it is not the intent of this paper to provide an exhaustive history of the FCC's findings and conclusions on rate of return regulation, it is worth noting some of the specific infirmities the Commission has identified in past proceedings because these remain relevant to this day. In particular, many of the Commission's specific concerns over the incentives created by and the administration of a rate of return regulatory regime have, as will be discussed in a later section of this paper, been borne out by instances in which companies have been found to have manipulated the process for their benefit.

The first, and most comprehensive, evaluation of rate of return regulation by the Commission was conducted in the Price Cap proceeding in the late 1980s⁴, in which it replaced rate of return with price cap regulation as the mechanism for overseeing the interstate rates charged, initially, by AT&T and later the large ILECs. In the Notices and Orders in this proceeding, the Commission laid out in considerable detail its findings on the problems created by the incentives and administration of a rate of return regulatory regime. Principal among these were

- Incentive to Pad Costs - "(R)ate of return regulation provides regulated firms with very strong incentives to pad their rates, for essentially two reasons. First, as a profit-maximizer, the firm is led to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base. This is commonly known as the Averch-Johnson effect of rate of return regulation. Second, since all operating expenses are included in a firm's revenue requirement under rate of return, management has little incentive to minimize operating costs. This is commonly known as 'X-inefficiency'. The firm's shareholders profit from the first phenomenon and the benefits of the second redound to the firm's management. In both cases, however, consumers suffer because these distorted incentives increase the cost of doing business –and thus the rates consumers must pay for service"⁵ The impact of this was clearly demonstrated by the fact that, in 1990, "the Common Carrier Bureau has been able to identify and disallow over \$2.7 billion in LEC access charges since 1985."⁶
- Lack of Incentives to Innovate - "The distorted efficiency incentives established by rate-of-return regulation also may have a negative effect on innovation. Clearly, rate-of-return establishes no incentive to 'do the same old thing a better way' – for example, by providing the same service at lower cost – because a carrier's reward for such innovation is a reduction in its dollar earnings. Such regulation may well have similar effects on incentives to produce new products and services. The limit on the ability of a carrier to earn returns on risky investments comparable with such risks, together with the potential that an unsuccessful project will result in cost disallowance, provide a reasonable basis to conclude that carriers have reduced incentives to undertake such risks under rate-of-return regulation. At best, rate-of-return regulation is 'passive' vis-à-vis innovation, neither fostering it nor encouraging it. We think the public interest is better served by the adoption of regulatory methods more attuned to stimulating innovation."⁷
- Potential for Cross-Subsidization - "Carriers subject to this (rate of return) regulatory approach have an incentive to shift some of the costs of providing unregulated competitive services to regulated services, where they can be recovered from ratepayers rather than the consumers of regulated services who rightfully bear these costs. In so doing, the carrier can increase its profits and simultaneously disadvantage its competitors."⁸

"(W)e disagree with those who suggest that cross-subsidization can be addressed easily under rate-of-return regulation through 'active and consistent oversight'. Such claims understate the difficulties inherent in oversight activities and ignore the long history of these difficulties. Concerns about different kinds of cross-subsidization have, in a very real sense, dominated federal telecommunication regulation since the advent of

competition in the 1950s, and were determined to be so intractable as to justify the draconian solution of divestiture of the Bell System. During the past few years, of course, we have implemented a number of regulatory techniques to discourage cross-subsidization between regulated and unregulated activities and improve our oversight capabilities. While these steps will act as a strong deterrent to cross-subsidization activities, our policies and programs can do no more than deter and attempt to detect such activities, they cannot eliminate the powerful incentive that rate-of-return regulation establishes to engage in cross-subsidization."⁹

- Administrative Transparency - "(A)dmistering rate of return regulation in order to counteract these incentives is a difficult and complex process, even when done correctly and well. (S)uch regulation is built on the premise that a regulator can determine accurately what costs are necessary to deliver service. In practice, however, a regulator may have difficulty obtaining accurate cost information as the carrier itself is the source of nearly all the information about its costs. Furthermore, no regulator has the resources to review in detail the thousands of individual business judgments a carrier makes before it decides, for example, to install a new switching system."¹⁰

There is no evidence to indicate, and considerable evidence to the contrary, that rate of return regulation as applied to establish universal service funding and interstate access rates for the rural ILECs avoids the pitfalls identified by the Commission over a decade ago. The incentive to pad costs, lack of incentives to innovate, potential for cross-subsidization and lack of transparency of the underlying cost data are as much problems today as they were then.

In subsequent proceedings, the Commission has reaffirmed its rejection of rate of return regulation, albeit without the detailed analysis it undertook in the Price Cap proceeding. In the Local Competition proceeding, which established the pricing standards for unbundled network elements and interconnection, the Commission found that

(A) cost-based pricing methodology based on forward-looking economic costs is the approach for setting prices that best furthers the goals of the 1996 Act. In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market-determined prices and forward-looking economic costs... New entrants should make their decisions whether to purchase unbundled elements or build their own facilities based on the relative economic costs of these options. By contrast, because the cost of building an element is based on forward-looking economic costs, new entrants investment decisions would be distorted if the price of unbundled elements were based on embedded costs."¹¹

The Commission went on to elaborate

We are not persuaded by incumbent LEC arguments that prices for interconnection and unbundled network elements must or should include any difference between the embedded costs they have incurred to provide those elements and their current economic costs. Neither a methodology that establishes prices for interconnection and access to network elements directly on the costs reflected in the regulated books of account, nor a

price based on forward-looking costs plus an additional amount reflecting embedded costs, would be consistent with the approach we are adopting. The substantial weight of economic commentary in the record suggests that an 'embedded cost'-based pricing methodology would be pro-competitor—in this case the incumbent LEC—rather than pro-competition. We therefore decline to adopt embedded costs as the appropriate basis of setting prices for interconnection and access to network elements.¹²

In this proceeding, unlike the Price Cap and Universal Service (discussed below) proceedings, no exception to forward looking economic cost (FLEC) based pricing requirements was made for rural ILECs.

Finally, in establishing a universal service support mechanism for non-rural carriers, the Joint Board (later affirmed by the Commission) again found that the application of FLEC using a proxy model to establish support levels would best meet the Act and the Commission's universal service objectives. The Joint Board stated:

We conclude that setting support at forward-looking economic cost levels will allow us to construct a universal service support mechanism that will preserve and advance universal service and encourage efficiency. Competitive firms will provide service using an approximately efficient level of resources because, in those instances when revenues are not sufficient, the support mechanism will provide the additional funds required to maintain service. In principle, using cost estimates generated by proxy models is a reasonable technique for determining forward-looking costs. Proxy models, because they are not based on any individual company's costs, provide a competitively neutral estimate of the cost of providing supported services.¹³

In this proceeding, both the Joint Board and Commission indicated their intent eventually to base universal service support for rural carriers on forward-looking costs, but, because "the proposed models could not at this time precisely model small, rural carriers' cost"¹⁴, the Commission would continue to use a slightly modified version of the existing embedded cost-based mechanisms until January 1, 2001. The Commission found that this would provide sufficient time to develop a model that would accurately predict rural carriers' forward-looking economic costs. Nevertheless, the Commission fully recognized the problems with continuing to use an embedded cost mechanism for rural carriers, stating,

We find that the current support mechanisms neither ensure that ILECS are operating efficiently nor encourage them to do so. Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high cost funding mechanisms effectively discourage efficiency. Thus, we agree with CSE that calculating high cost support based on embedded cost is contrary to sound economic policy. We conclude that basing support on forward-looking economic cost or perhaps competitive bidding will require telecommunications carriers to operate efficiently and will facilitate the move to competition in all telecommunications markets.¹⁵

The Joint Board then established the Rural Task Force (RTF) to recommend modifications to the high cost support mechanisms for rural carriers. The RTF found that significant anomalies resulted when the FCC's synthesis (proxy) model was applied to rural carriers, including large differences between model results and actual data for line counts, wire center areas, route miles of outside plant, type of outside plant construction, COE investment and other costs.¹⁶ As a result, the RTF recommended that the Commission continue to use a modified embedded cost mechanism until 2006 to allow time to develop a long term rural mechanism that functions efficiently, is better coordinated with the non-rural mechanism, and effectively targets support to rural carriers serving the highest cost areas. The Commission subsequently adopted the RTF's recommendation.¹⁷

Although Western Wireless will continue to support maintaining the status quo until 2006, the Company believes it is time for the Commission and the Joint Board to begin a concerted effort to develop a FLEC model that effectively and accurately estimates the efficient cost of providing supported services for rural carriers. This effort could also involve a review of the existing synthesis model used for non-rural carriers and the inclusion of wireless costs to ensure a coordinated approach to universal service funding for all segments of the industry. The development of a new FLEC model should commence as soon as possible because the process will inevitably be controversial and require considerable time and resources (similar to the process of developing the synthesis model). However, Western believes that, due to advances in modeling, mapping and geocoding techniques since the development of the synthesis model, the problems in the application of that model to rural carriers identified by the RTF can potentially be overcome.¹⁸

As was discussed above, the Commission has fully evaluated the effectiveness of and incentives created by rate of return regulation and consistently found it wanting. These problems have not been cured by the passage of time. As will be discussed in the next section of this paper, in those few publicly documented instances in which the Commission (or the NECA) has been compelled to fully investigate the data reported by rate of return carriers, they have almost inevitably found serious problems. None of this is surprising and provides further evidence of the need to abandon rate of return regulation for all telecommunications carriers.

Manipulation of the Rate of Return Process

Unsurprisingly, carriers frequently act on the incentives created by rate of return regulation. This is especially true with respect to interstate intercarrier compensation received by ILECs under rate of return mechanisms, such as access charges, settlements, and universal service funding. As a mechanism for collecting revenue, intercarrier compensation has a number of advantages over the provision of retail services, especially for smaller ILECs: the process is well established and operates relatively automatically (through NECA, USAC and CABS), there are no marketing costs, revenues are relatively unaffected by a company's own customers' demand elasticities, historically (at least until the WorldCom and Global Crossing bankruptcies), there were very low levels of uncollectibles, and, the level of scrutiny of reported costs is relatively low (especially in comparison to the scrutiny accorded in state rate case and show cause proceedings). Consequently, rate of return ILECs have every incentive, and in many cases the

ability, to maximize their revenues from interstate access services and the universal service fund and it appears they have done so

There are a number of indicators that suggest rate of return ILECs have engaged in, or attempted to engage in, interstate revenue maximization over the years. For example, as was noted above, the FCC in 1990 indicated that they had disallowed over \$2.7 billion in LEC access charges since 1985 under rate of return regulation.¹⁹ In addition, in its Comments, Western identified an increase of over \$191 million in the ILEC portion of the USF since 1999 that cannot be explained by regulatory changes (MAG, CALLS and RTF) implemented during that period.²⁰ Further, AT&T, in a recent ex parte filing, showed that rate of return carriers filing Form 492 Reports had experienced interstate overearnings of over \$218 million in the 2001-2002 period, following overearnings of approximately \$92 million in 1999-2000 and \$121 million in 1997-1998.²¹ These indicators clearly show that carriers have acted on the incentives created by rate of return regulation and, apparently, increasingly successfully in recent years.

There have been a number of instances in the relatively recent past in which rate of return carriers have been found to have violated or egregiously manipulated the Commission's accounting and costing rules in order to maximize their interstate revenues. While Western believes that these examples merely represent the tip of the iceberg, they are illustrative of ways in which carriers have acted on the incentives created by rate of return regulation. They also provide some guidance on areas in which the Commission could enhance its oversight of rate of return carriers until it can implement a FLEC model for determining all carriers' universal service receipts.

Virgin Islands Telephone Company (VITELCO) Interest Expense

In 1990, VITELCO filed a Request for Declaratory Ruling with the Commission to resolve a dispute with NECA (of which it was a member) over the treatment of interest expense in its cost study. Atlantic Tele-Network Company had purchased VITELCO from ITT and borrowed approximately \$100 million to finance the purchase, of which \$60 million was recorded on VITELCO's books. VITELCO took the position that it should not be required to deduct the interest expense from its return allowance for the purpose of determining its federal income tax expense for ratemaking purposes (which would decrease its interstate revenue requirement). The Commission, however, disagreed, noting that the company's regulated plant was pledged as security for the loan and upheld NECA's interpretation of this issue.²²

Direct Assignment under Part 36

When the Commission replaced the Part 67 jurisdictional separations procedures with Part 36 in 1987,²³ it allowed for the direct assignment of certain plant costs to the interstate or intrastate jurisdiction if the facility was used exclusively to provide interstate or intrastate services. A number of carriers began to use direct assignment quite extensively, most of which were direct assignments to interstate services, and the Commission was forced to clarify that it intended a relatively limited role for direct assignment in the separations process.²⁴ In particular, the Chesapeake and Potomac Telephone Company had attempted to construe an allocation of trunk testing expense it had developed as a permitted direct assignment and a number of carriers

directly assigned portions of corporate operations expense rather than use the prescribed allocation factor. In each of these instances, the Commission rejected the carriers' position as a misinterpretation of Part 36.²⁵

NECA Audits of the RBOCs' Common Line Pool Reporting

The Commission had found that the RBOCs had made some unusually large adjustments to the NECA Common Line (CL) Pool in December 1988 (shortly before they were permitted to exit the Common Line Pool), adjustments apparently encouraged by RBOC members of the NECA Board. As a result, the Commission ordered NECA to commission an audit of the RBOCs' reported adjustments to the CL Pool from January 1988 through March 1989. The results of this audit revealed misstatements or miscalculations of interstate costs and revenues during this period of \$37.8 million for NYNEX, \$23.2 million for Bell Atlantic, \$22.8 million for Ameritech, \$16.2 million for US West, \$9.7 million for Southwestern Bell, \$6.2 million for Bell South and \$3.4 million for Pacific Bell. Most of these misstatements were found to have benefited the companies at the expense of interstate ratepayers. The audit uncovered a wide range of violations of Parts 32, 36, 64, 65 and 69 of the Commission's Rules and related policies.²⁶ Subsequently, each of the RBOCs entered into Consent Decrees with the Commission which required the carriers to, depending on the individual carrier, make exogenous price cap adjustments of up to \$13.7 million (Bell Atlantic), conduct audits of their internal controls and/or correct their accounting practices to conform to the Commission's Rules.²⁷

1997 Annual Access Tariff Filings-Cash Working Capital

In investigating the 1997 annual access tariff filing of several rate of return carriers, the Commission identified significant problems with the lead-lag studies used by these carriers to develop the cash working capital component of the rate base. The Commission had established a 15-day standard allowance (i.e. revenues are collected, on average, 15 days after the payment of cash expenses) which, when multiplied by average daily cash expense, produces the rate base cash working capital allowance. Carriers are, however, allowed to use a longer net lag if supported by a properly performed lead-lag study.²⁸ The cash working capital of four carriers was based on net lag days far in excess of the standard allowance, ranging from 46 days for Concord Telephone Company to 71.8 days for Puerto Rico Telephone Company. The Commission's review of the companies' lead lag studies revealed a raft of problems, including large out-of-period or retroactive adjustments, outdated studies that failed to reflect current operations, and inconsistent study periods. Consequently, the Commission ordered all four carriers to revert to the 15-day standard allowance and provide refunds with interest.²⁹

ACS of Anchorage Traffic Factors

In 2000, GCI (an Alaskan IXC and CLEC) filed a complaint alleging that ATU, ACS' predecessor, had been counting ISP traffic as interstate, rather than intrastate, and counting only a single dial equipment minute (DEM) rather than two for intraoffice local calls in developing its interstate traffic sensitive access rates. This was in direct contravention of established Commission policies and resulted in ATU earning a rate of return on its traffic sensitive services of over 32%, far in excess of its allowed rate of return of 11.25%. The Commission ruled

against ATU and awarded damages with interest³⁰ Subsequently, in December, 2001, in its tariff filing in response to the MAG Order, ACS of Anchorage continued to use as its baseline revenue requirement for this filing, the same revenue requirement it had used in 2000 i.e. based on the traffic factors disallowed by the Commission Consequently, the Commission rejected ACS' filed rates as unjust and unreasonable to the extent they were based on the unlawful traffic factors³¹

Moultrie Independent Telephone Company High Cost Reporting

In 1997, Moultrie Independent Telephone Company, a small rural ILEC in Illinois, transferred ownership of many of its non-loop assets to an affiliate and then leased them back at cost to the telephone company, treating the lease cost as an operating expense and excluding the asset costs from the rate base When Moultrie submitted its 1997 cost study to the NECA, this treatment resulted in its high cost loop fund payments going from \$15 per year per loop to \$433, as Moultrie's accounting treatment resulted in a much larger proportion of its operating expenses being assigned to the loop element NECA rejected Moultrie's cost study on the ground that it violated the Part 36 requirement that, when substantial amounts of property are leased back to a company by an affiliate for cost study purposes, the property should be treated as if it is owned by the telephone company The Commission upheld NECA's interpretation and ordered Moultrie to resubmit its cost studies reflecting the proper treatment of the sale-leaseback transaction³²

Clearly, carriers have acted on the incentives created by rate of return regulation in order to maximize their interstate USF and access revenues The examples cited above likely represent only those instances in which the attempt to manipulate the process was sufficiently blatant that the NECA, interveners and/or the Commission stepped in to address and remedy the violations Other instances likely either remain undetected or are dealt with through the NECA/USAC oversight functions Unfortunately, the results of these organizations' audits or reviews of carriers' USF related data reporting are not publicly available, so Western is unable to evaluate the effectiveness of these oversight functions

Enhancement of the USF Oversight Process

Western strongly believes that high cost support for all carriers should be based on an appropriately designed FLEC model to eliminate the incentives to pad costs, enhance efficiency incentives, eliminate the potential for cross-subsidization and render the underlying input data transparent to all parties, not just the ILECS Nevertheless, Western commits to maintaining the status quo through 2006 and recognizes that such a model will take at least that long to develop Until that time, or if the effort to develop a FLEC model for rural carriers is ultimately deemed infeasible, Western believes that enhanced oversight of the cost and line count data submitted by ETCs may go a long way towards stemming the growth of the high cost fund

A number of factors suggest that stronger oversight of the high cost fund is necessary to enhance the transparency of the process and limit the potential for abuse:

- While NECA does review rate of return carriers' cost study and high cost fund submissions, the scope and outcomes of these reviews are not made public. Consequently, it is not possible for outside parties to evaluate the effectiveness of these reviews and their effect on carriers' compliance with the Commission's Rules and policies.
- NECA simply does not have sufficient staff to conduct stringent reviews/audits of all carriers' cost data. According to its web site, NECA has only 48 "Member Services" staff, the personnel responsible for cost study reviews, in its seven regional offices. Because these NECA personnel also have other responsibilities and over 1,500 companies¹¹ receive high cost support, it would be physically impossible for NECA to conduct comprehensive reviews of all or even a significant number of carriers' cost data. Further, USAC had only seven internal auditors and spent only a little over a million dollars in 2002 on external audit services for oversight of all the USF programs, not just high cost.¹⁴
- Given the composition of its Board of Directors, it is unclear whether NECA is sufficiently independent of rate of return ILEC interests to support a strong oversight function. Of its fifteen member Board of Directors, six are from Subset Three, representing the smaller ILECs, the two Subset Two Directors, representing the midsize ILECs, are from rate of return carriers that receive considerable USF (Century and TDS) and, of the five outside Directors, two are former RUS administrators and one is from an affiliate of a rate of return ILEC.
- While the well publicized problems with the E-Rate programs have not yet spilled over into the high cost fund programs, these problems demonstrate that participants do act in the incentives created by these programs and that the existing oversight functions have not been adequate to curb the potential for abuse.

In order to enhance oversight of the high cost programs, Western recommends that the following programs and policies be put in place:

- Carriers' cost studies and other data submissions supporting their high cost funding should be made publicly available. Inasmuch as USF is essentially a form of public funding, the basis for this funding should be a matter of public record. The data available would include Part 36 and 69 cost studies and supporting workpapers, the company's Part 64 Manual and resulting regulated/nonregulated cost allocations, details of all affiliate transactions involving the regulated telephone operation, financial statements for the telephone company and all its affiliates, LSS and HCL calculations, and line counts. As this is similar to the type of data provided by rate of return carriers subject to the FCC's Tariff Review Process and in state rate cases, there is ample precedent for making this type of data available for public scrutiny. Carriers would have the opportunity to request confidentiality for any data considered competitively sensitive. Given that many of the attempts to manipulate the rate of return process discussed in the previous section were first identified by parties other than the Commission or NECA, this expansion of the universe of "overseers" would facilitate the identification of potential instances of abuse.

- The results of any reviews of cost studies or other data submissions involving high cost funding conducted by NECA or USAC over the past three years should be made publicly available. This would enable outside parties to evaluate the effectiveness of the existing oversight process. Again, there is precedent for releasing such information, for example, the FCC's release of the results of its audits of the RBOCs' continuing property records ("CPRs") in 1999.¹⁵
- If, as Western suspects, review of the information provided pursuant to the above recommendations indicates that the existing oversight processes are inadequate to detect many instances of abuse, an enhanced audit/review process should be put in place. This process should have the following features:
 - Audits of the data underlying the high cost submissions of every carrier receiving "substantial amounts of USF would be conducted every three years, more frequently if there were a significant increase in a company's year over year funding requests. The audits would encompass the previous three years of data submissions.
 - The audits would be conducted by truly independent firms (*i.e.*, public accounting firms, *not* consulting firms with other relationships with rural ILECs) following a scope of work approved by the Commission.
 - To ensure independence, the audit firm(s) would be selected and supervised by the FCC and/or USAC.
 - The audits would be conducted on relatively short notice to ensure company records weren't manipulated or falsified.
 - Companies would be required to provide full access to their books and records.
 - The results of the audits would be made publicly available.
 - Companies found to have violated the Commission's Rules and policies in their submissions would not only be required to repay the amount of excess funding received but would be subject to fines for significant violations e.g. claiming more than 110% of what they were due. In truly egregious cases, the carrier would become ineligible for future funding.

Western believes these audits should be as comprehensive as possible to ensure the integrity of the high cost funding process. While it is not the intent of this paper to fully define the scope of work for the audit process, at least the following types of issues should be reviewed:

- Loop Counts – Are all loops classified accurately (especially those between the switch and ISPs and ISDN-PRI versus digital trunk lines)? Are subscriber line charges assessed correctly?

- Investment Classifications – Are only facilities providing service in the study area reflected in reported costs? Do the company's CPRs and circuit counts support the assignment of C&WF between the subscriber, exchange trunk, interexchange and host/remote categories? Are remote switches and concentrators appropriately classified according to RAO Letter 21? Are the costs of Class 4/5 switches accurately allocated between the tandem and local switching categories? Are DSL costs fully captured and assigned to the appropriate categories and jurisdiction based on the speed and type the services provided? Are all building costs, especially CO buildings, treated as such? Do direct assignments of investments or expenses conform to Commission policies?
- Part 64 – Does the company maintain and follow an up-to-date Part 64 Manual? Does it conform to the Commission's prescribed cost allocation hierarchy? Are adequate internal controls in place? Is the general allocator appropriately developed and applied?
- Affiliate Transactions – Are only recoverable costs under the Part 65 Rules included in management fees or other charges from unregulated affiliates (excluding items such as acquisition adjustments, lobbying costs, etc)? Are these charges booked to the correct Part 32 accounts for the functions provided by the affiliate? Do any sale and lease back arrangements reflect the Part 36 substantial property requirement?
- Accounting Classifications – Are costs, especially those that would be subject to the HCL Fund corporate cap, booked to the correct Part 32 accounts? Is interest expense on debt secured by the assets of the telephone company shown on the regulated books and reflected in calculation of federal and state income tax allowances? Is interest during construction calculated correctly and reflected as a revenue requirement offset?
- Cash Working Capital – If the company does not use the 15-day standard allowance, does it have a current lead-lag study that follows the Commission's prescribed policies and practices? Do the minimum bank balances reflect only compensating balances?

Western believes that independent audits of company reporting practices that address issues such as those identified above would produce high cost fund savings far in excess of the cost of the audits themselves.

Conclusion

The Commission has evaluated rate of return regulation in a variety of contexts over the last fifteen years and consistently found that it fails to meet its regulatory objectives. The incentive to pad costs, lack of incentives to innovate, potential for cross-subsidization and lack of transparency remain fundamental and intractable problems that have defied solution. And, as the examples provided in this paper demonstrate, companies have frequently acted on the incentives created and attempted to manipulate the system to their benefit. Adoption of an effective FLEC model to develop all carriers' universal service costs and funding would enable the Commission to abandon the failed rate of return mechanism once and for all. Until such time as a reliable and accurate FLEC model can be developed, or if that proves infeasible, until a viable alternative can

be developed, more stringent oversight of the high cost funding and reporting process should be instituted as proposed in this paper

1 Rate of return regulation is also referred to as rate base/rate of return, revenue requirement and embedded cost (at least since the abandonment of the fair value standard of asset valuation) regulation. These terms will be used interchangeably herein.

2 See map *Retail Regulation of Local Telecommunications Providers*, NRRF, January 2003.

3 See *The Legal and Historical Background of the Federal Universal Fund System*, Hogan & Hartson, Attachment A to Western Wireless' Comments in this proceeding.

4 Re *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313 ("Price Caps").

5 Price Caps, Further Notice of Proposed Rulemaking, FCC 88-172, Para. 39 (1988).

6 Price Caps, Second Report and Order, FCC 90-314, Para. 234 (1990).

7 Price Caps, Further Notice, Op. Cit. Para. 46-47.

8 *Id.* Para. 48.

9 *Id.* Para. 52.

10 Price Caps, Report and Order and Second Further Notice of Proposed Rulemaking, FCC 89-91, Para. 31 (1989).

11 Re *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98, FCC 96-325, Para. 620 (1996).

12 *Id.*, Para. 705.

13 Re *Federal-State Joint Board on Universal Service*, Recommended Decision, CC Docket No. 96-45, FCC 96J-3, Para. 276 (1996).

14 Re *Federal-State Joint Board on Universal Service*, Report and Order, CC Docket No. 96-45, 12 FCC Red. 8776, Para. 291 (1997).

15 *Id.*, Para. 292.

16 Rural Task Force, White Paper No. 4, *A Review of the FCC's Non-Rural Universal Service Fund Method and the Synthesis Model for Rural Telephone Companies*, September 2000.

17 *Federal State Joint Board on Universal Service, and Multi-Association Group Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256, 16 FCC Red. 11244 (2001).

18 See *Proposal for a Competitive and Efficient Universal Service High Cost Funding Model/Platform* James Stegeman, Attachment I to Western's Comments.

19 See fn. 6.

20 See fn. 3, p. 6.

21 AT&T, Notice of Ex Parte Filing, CC Docket Nos. 00-256, 96-45, 98-77 and 98-166, May 9, 2003, Exhibit I.

22 Re *Virgin Islands Telephone Company*, Memorandum Opinion and Order, AAD 90-19, DA 90-143 (1990), DA 91-707 (1991), FCC 92-504 (1992).

23 Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, *Recommended Decision and Order*, 2 FCC 2d 2582 (1987).