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March 15, 2004

By Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th St., SW
Washington, D.C. 20554

Re: CC Docket Nos. 93-193; 94-65 and 94-157

Dear Ms. Dortch:

I write this letter on behalf of AT&T Corp. ("AT&T") in response to recent *ex parte* submissions in which Verizon attempts to justify unlawful increases in its 1993/94 and 1994/95 interstate access tariffs based on accounting changes that it voluntarily adopted in 1991 and 1992. This issue applies only to Verizon, because no carrier other than Verizon's predecessor Bell Atlantic sought such clearly unlawful rate increases.

In 1990, the Federal Accounting Standards Board ("FASB") adopted Statement of Financial Accounting Standards Number 106 ("SFAS-106"), which established new financial accounting and reporting requirements for other post-employment benefits ("OBEBs"). In December 1991, the Commission issued an order that required LECs, by January 1, 1993, to conform their regulatory books with the new SFAS-106 financial accounting rules.[1] Verizon chose *voluntarily* to implement the accounting change in its regulatory books well before it was required to do so. Verizon states that on December 31, 1991, it notified the Commission that it would implement the SFAS-106 rules immediately (and retroactively) as of January 1991. *See* Verizon Direct Case at 4. Then, in its 1993/94 and 1994/95 interstate access tariffs Verizon sought to recover purported costs associated with its voluntary early adoption of SFAS-106 by increasing its interstate access rates, claiming that its voluntary early adoption of SFAS-106

[1] *Southwestern Bell Corporations, GTE Services Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions*, 6 FCC Rcd. 7560, ¶¶ 3, 5 (1991).

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resulted in "exogenous" cost increases that justified increases to price cap indices ("PCIs"). The Commission immediately suspended Verizon's tariffs, finding "their justification . . . sufficiently questionable."[2]

There is no longer any dispute on the merits that allowing Verizon to keep the rate increases it collected in connection with the 1991/92 period of voluntary early adoption would be to grant Verizon a pure windfall at the expense of ratepayers. As the Commission ruled in 1995, the SFAS-106 accounting change had absolutely no cash flow or other economic impact.[3] Rather, Verizon's argument here is that the Commission's rules in place at the time of the tariff filing do not allow the Commission to reach the unquestionably correct outcome and require long delayed refunds.

To the contrary, there were two separate Commission rules in place in 1993, each of which independently forecloses the Verizon rate increases. First, the Commission's *1990 Price Cap Order* made clear that "no GAAP change can be given exogenous treatment until FASB has actually approved the change *and it has become effective*."[4] It is undisputed that the "effective" date of SFAS-106 was, as expressly stated in the order promulgating that rule, December 15, 1992.[5] The Commission's rules therefore prohibited Verizon from making any exogenous cost adjustment for any SFAS–106 costs incurred prior to December 15, 1992.

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[2] Order of Investigation and Suspension, *Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, Employers Accounting for Postretirement Benefits Other Than Pensions; Bell Atlantic Tariff F.C.C. No. 1; US West Communications, Inc., Tariff F.C.C. Nos. 1 and 4; Pacific Bell Tariff F.C.C. No. 128,* 7 FCC Rcd. 2124, ¶ 8 (1992).

[3] First Report and Order, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd. 8961, ¶ 309 (1995) ("*1995 Price Cap Performance Order*").

[4] Second Report and Order, *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd. 6786, ¶ 168 (1990) ("*1990 Price Cap Order*") (emphasis added). *See also* Order on Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd. 2637, ¶ 59 (1991) ("*1991 Price Cap Reconsideration Order"*) ("no carrier c[an] treat GAAP changes as exogenous until [the Commission] approve[s] the changes, and that exogenous treatment will not be granted until FASB ha[s] actually approved a change in GAAP, and the change has become effective"); *1995 Price Cap Performance Order* ¶ 275 (exogenous cost treatment would only be accorded to GAAP changes "that have been adopted by the Financial Accounting Standards Board ("FASB") and have become effective"); *cf. American Tel. and Tel. Co. Revisions to Tariff FCC Nos. 1, 2, and 13*, 5 FCC Rcd. 3680 (1990) (denying exogenous cost treatment based on AT&T's switch from cash basis to accrual accounting for post-employment health and welfare benefits because AT&T implemented this change before FASB adopted a new rule requiring it).

[5] *See* SFAS 106 (Attachment B to Verizon's Direct Case) at ¶ 108 ("this Statement shall be effective for fiscal years beginning after December 15, 1992"); *see also id.* at 1 ("Effective Date:

Verizon's only response is that the relevant "effective date" should not be the date on which the FASB rule change itself became effective, but instead the date on which Verizon chose to make the rule effective for its own internal accounting purposes. That interpretation of the rule is foreclosed by both its plain language and clear Commission precedent. In this regard, in an earlier 1990 order the Commission rejected AT&T's attempt to obtain exogenous cost treatment in connection with AT&T's own voluntary early adoption of SFAS-106.[6] Like Verizon here, AT&T had argued that FASB would soon adopt the SFAS-106 changes and would make those changes mandatory by 1992 and that AT&T had internally already made those changes effective. The Commission squarely rejected AT&T's claims for exogenous treatment, and it must do the same with respect to Verizon's claims for exogenous treatment for periods prior to the effectiveness of SFAS-106.[7]

In all events, any costs associated with the 1991/92 period of early voluntary adoption plainly did not satisfy the definition of "exogenous cost" under the Commission's 1993 rules. As the Commission has repeatedly explained, and as the courts have affirmed, LECs are permitted to obtain exogenous cost treatment only for costs that are "beyond the[ir] control." *1990 Price Cap Order* ¶ 166; *Southwestern Bell*, 28 F.3d 165, 170 (D.C. Cir. 1994). The Commission did not require Verizon to reflect SFAS-106 in its accounting books until January 1, 1993. Any implementation of SFAS-106 prior to January 1, 1993 was therefore entirely within Verizon's control. Accordingly, any costs related to such early implementation could not be treated as exogenous costs within the meaning of the Commission's rules, and thus could not be used to increase price caps. Simply put, Verizon was free to implement SFAS-106 in its regulatory books at any time, but Verizon could not seek exogenous cost increases for any purported SFAS-106 related costs incurred prior to January 1, 1993. Because Verizon's price caps could not lawfully be increased, Verizon's rate increases resulted in rates that exceeded Verizon's lawful price caps by more than $7.4 million. *See* Exhibit A, attached hereto.

Contrary to Verizon's assertions, *Southwestern Bell,* 28 F.3d 165, supports this straightforward application of the 1993 rules. In *Southwestern Bell,* the Court did nothing more

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For fiscal years beginning after December 15, 1992"); *1995 Price Cap Order* ¶ 276 ("In December 1990, the FASB adopted SFAS-106, which requires companies to account for other post-retirement benefits on an accrual basis beginning December 15, 1992.").

[6] Memorandum Opinion And Order, American Telephone and Telegraph Company Revisions to Tariff FCC Nos. 1, 2, and 13, Transmittal No. 2304, 5 FCC Rcd. 3680 (1990).

[7] *Id.* ¶ 3. Verizon's proposed interpretation would render the effective date rule meaningless. Under Verizon's interpretation of the rules, all carriers could obtain exogenous cost treatment for any accounting change adopted by the FASB and the Commission, regardless of whether the rule change had formally become effective, *i.e.,* mandatory for all carriers. Indeed, the requirement that exogenous costs could be sought only after the "effective date" of the rule change that caused those costs would be meaningless, as each carrier could unilaterally set its own "effective date."

than reject a prior Commission finding that the "control" test could be interpreted to mean that a LEC maintains control, even after an accounting change has become "mandatory," simply because the LEC retains control of the underlying OPEB costs – *e.g.,* the LEC retains the ability to control the types of post-retirement benefits it pays to its employees. The Court reasoned that such an "underlying control" criterion was not part of the Commission's "control" test under the existing rules. *Southwestern Bell*, 28 F.3d at 170, 173. Here, by contrast, AT&T urges the Commission to recognize only that Verizon had complete control over its decision to implement SFAS-106 early, which is fully consistent with the D.C. Circuit's holding. As the Court explained, the SFAS-106 accounting change was "outside the control" of carriers "*once mandated by the Commission.*" *Southwestern Bell*, 28 F.3d at 170. Thus, under the classic control test applied in *Southwestern Bell*, Verizon maintained complete control over whether to adopt SFAS-106 prior to January 1, 1993, and such costs, therefore, are not "exogenous" costs that can be recovered through subsequent rate increases. 47 C.F.R. § 61.45(d).[8]

Recognizing that exogenous cost treatment of its early adoption of SFAS-106 in its 1993/94 and 1994/95 tariffs is barred by multiple Commission rules and orders, Verizon offers an alternative defense. According to Verizon, it should not be subject to refunds because it had sufficient "headroom" in the 1993/94 tariff period, even without additional exogenous cost increases to its price caps.[9] That, too, is wrong. Verizon argued in its reply comments that it could avoid refunds even in price cap baskets in which it concededly lacked headroom (the special access basket) by applying headroom that existed in other baskets (the common line and traffic sensitive baskets). But the price cap rules operate on individual baskets, not collectively for all baskets, and the Commission has repeatedly rejected LEC attempts to "borrow" headroom from one basket to avoid refund obligations in another basket. *See*, *e.g.*, *In the Matter of 800 Data Base Access Tariffs and the 800 Service Management System Tariff and the Provision of 800 Services*, Order on Reconsideration, 12 FCC Rcd. 5188, ¶ 17 (1997) ("*800 Database Recon. Order*) ("We . . . find unpersuasive arguments by various incumbent LECs that we should not require refunds because they could have raised rates in other baskets").[10]

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[8] Verizon makes much of the fact that it was "permitted" and "encouraged" to make the accounting change prior to January 1, 1993, but that is irrelevant to the question whether such cost changes are *exogenous*. As explained above, a cost change is exogenous only if it is truly beyond the control of the carrier, and prior to January 1, 1993, cost changes related to SFAS-106 were not.

[9] The maximum average revenue for any given basket is reflected in the PCI for that basket. 47 C.F.R. § 61.45. The actual rates that the LEC charges for services in a particular basket are reflected in the average price index ("API"). If a LEC's API is below its PCI for a particular basket, then the LEC has "headroom," *i.e.,* it is charging prices lower than that permitted by the price cap rules. On the other hand, if a LEC's API exceeds the PCI for a particular basket, then the LEC's rates exceed those permitted by the Commission's rules.

[10] *See also In the Matter of 800 Data Base Access Tariffs and the 800 Service Management*

Recognizing that it cannot defend its rate increases using aggregate PCIs and APIs, Verizon offers its own creative, but equally unlawful, basket-by-basket approach. The 1993/94 tariff period ran from July 1, 1993 through June 30, 1994. During that time period, the Verizon rates at issue were governed by one basket and rate structure from July 1, 1993 through February 28, 1994 (the special access basket), and a second basket and rate structure from March 1, 1994 through June 30, 1994 (the new "trunking" basket). Under the first basket and rate structure, Verizon's API exceeded its PCI for its special access baskets by $5.4 million on an annualized basis (as illustrated in Exhibit A hereto). The second basket and rate structure, which started in March 1994, implemented new Commission rules that required Verizon to rearrange the costs allocated to different baskets and to create a new basket called "Trunking." The new trunking basket includes all of the special access basket, which had virtually no headroom, and transport costs that were formerly in the traffic sensitive basket. And when the transport costs were transferred to the new trunking basket, a portion of the traffic sensitive basket headroom was also effectively transferred into that new basket as well. Verizon's new accounting gimmick is to compute headroom in the special access basket for the entire 1993/94 accounting period by averaging the headroom under the two basket and rate structures – *i.e.*, treating the combination of baskets as if it had occurred in 1993.

Verizon has attempted such improper averaging before, and the Commission properly rejected it. Headroom is determined at a point in time – rates either exceed lawful PCI levels at that time or they do not, and a LEC cannot answer to claims that it was charging too much in one month by pointing out that it could have charged more in a subsequent month. In the 800 database proceeding, for example, several LECs, including Verizon's predecessors, tried to avoid refunds by averaging headroom available under different tariffs in effect during the same year. The Commission expressly rejected that "averaging" approach: "Regarding [the] . . . argument that [LECs] . . . should calculate their headroom amounts by not averaging the offset

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System Tariff and Provision of 800 Services, Memorandum Opinion and Order, 12 FCC Rcd. 8396, ¶ 11 (1997) ("*800 Data Base Order*"); *1990 Price Cap Order* ¶ 198 ("Baskets . . . are methods of restricting the degree of pricing flexibility that carriers would otherwise have if we adopted a theoretically pure price cap system. In a pure price cap system, all services offered by a carrier would be subject to a single price cap, and carriers would have unlimited ability to migrate individual prices up or down so long as aggregate prices remained below the cap. While a pure price cap system may appear attractive based on its potential for economic efficiency gains there are competing policy concerns that must be addressed in designing a system of price cap regulation for LECs. . . . [W]e will employ a system of baskets . . . to limit, but not eliminate, LEC pricing flexibility"). As the Commission has explained, "a cap on aggregate prices can result in some offerings being priced relatively high, while others are priced relatively low." *1990 Price Cap Order* ¶ 11. Therefore, to "defeat any LEC attempts to finance a predatory rate level by contemporaneously increasing rates for other services," *1996 Price Cap Order* ¶ 36, the Commission "adopt[ed] further ratepayer protections in the form of baskets, service categories, and pricing bands." *Id.*

for the entire year, but rather by comparing rates to caps at distinct points in time, we agree that such weighted averaging should not be allowed because it distorts the headroom calculation for those LECs." *800 Data Base Order* ¶ 13. Accordingly, the Commission required the LECs to compute refunds by comparing the APIs to their PCIs in the tariffs that were in effect for each time period. *Id.*

Correcting Verizon's error, and applying the proper computational methodology confirms that under Verizon's basket and rate structures from July 1993 to March 1, 1994, Verizon's API for the special access basket exceeded its PCI by $5.4 million on an annualized basis.[11] *See* Exhibit A, attached hereto. The rates using those basket and rate structures were effective for two thirds of the year, so Verizon is subject to refunds for *at least* two thirds of those annualized amounts, or $3.6 million, even if Verizon could be given headroom credit for the latter third of the tariff year.

And, given the circumstances, Verizon should not be given headroom credit for even the last third of the tariff year. There is no established method for computing refunds for the unique situation that arose in the last third of the 1993/94 tariff period. Ratepayers still were paying the same excessive special access rates that they were paying for the first two-thirds of the year because Verizon never lowered its rates – it was charging the same excessive special access rates that it was charging the first two thirds of the year. However, the basket restructuring reflected in that new tariff created the illusion that Verizon's excessive special access rates were legitimate, because the newly computed APIs fell below the newly computed PCIs for the new basket as a whole. In this unique situation, the Commission's usual method for measuring overcharges – *i.e.,* comparing the APIs to the PCIs for each basket – does not work, because such a comparison no longer provides a valid proxy for overcharges. The most equitable outcome in this situation is to compute refunds using the special access headroom (or, more precisely, the lack of special access headroom) that was in effect for the first two-thirds of the year. Because the special access rates in effect for the first two-thirds of the year were set to over-recover $5.4 million on an annualized basis, and those special access rates *were not changed* after the March 1 basket restructuring, the Commission should require Verizon to refund the full $5.4 million that was actually collected.

As for the refunds due in the 1994/95 tariff year, there was no basket restructuring, eliminating any opportunity for Verizon to apply "averaging." And Verizon and AT&T agree that during the 1994/95 tariff year, Verizon's APIs exceeded its PCIs for the common line, traffic sensitive, and trunking baskets, and the total amount of these overcharges is

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[11] Verizon actually filed two tariffs during this time period. The first Verizon tariff was effective on July 1, 2003. On November 15, 2003, Verizon filed a second tariff, effective January 1, 2004, using the same basket and rate structure as the July 1, 2003 tariff. Because that second tariff did not change the basket and rate structure AT&T did not include that tariff in its calculations. This approach works in Verizon's favor because the January 1, 2004 tariff had *less* headroom than the July 1, 2003 tariff.

more than $2 million. *See* Exhibit A (attached); Verizon March 1, 2004 *Ex Parte*, Attachment at 12.

For these reasons, Verizon cannot be accorded exogenous treatment for its early, voluntary adoption of SFAS-106. Accordingly, it owes ratepayers at least $7.4 million in refunds for the 1993/94 and 1994/95 tariff periods.

Respectfully submitted,

/s/ David L. Lawson

cc: Jay Atkinson
Sharon Diskin
Jeffrey Dygert
Aaron Goldschmidt
Jane Jackson
William Maher
Andrew Mulitz
Tamara Preiss
Clifford Rand

Exhibit A

Bell Atlantic
Amount Priced Below Cap for 1993/1994 Tariff Period

Attachment 1
(revises Exhibit 3 to Verizon's May 27, 2003 filing)

	1993 Annual Compliance #579 7/1/93				Indices and Rates in Effect on 6/30/1994			
	PCI or Maximum Allowable	API or Rate	Revenues	Amount Below	PCI or Maximum Allowable	API or Rate	Revenues	Amount Below
	A	B	C	D=((B-A)/A)*C	A	B	C	D=((B-A)/A)*C
Terminating CCL Premium	0.00917	0.008829	270288491	(10,051,077)	0.009197	0.008855	228490026	(8,496,639)
Terminating CCL Non Premium	0.004127	0.003973	46299	(1,728)	0.004139	0.003985	31633	(1,177)
Originating CCL Premium	0.00917	0.008829	183214208	(6,813,091)	0.009197	0.008855	250332466	(9,308,873)
Originating CCL Non Premium	0.004127	0.003973	6648	(248)	0.004139	0.003985	4108	(153)
Traffic Sensitive	88.8299	86.3836	934350644	(25,731,223)	88.9248	86.4752	485937801	(13,386,066)
Special Access	88.517700	88.4812	369094125	(152,195)				
Trunking					90.0006	88.4832	853110660	(14,383,350)
Interexchange	98.658300	97.4858	141755085	(1,684,682)	98.8142	97.4858	142238351	(1,912,169)
Total				(44,434,244)				(47,488,427)

SOURCES

	1993 Tariff Review Plan of BATR/TM # 977				1994 Tariff Review Plan of BATR/TM # 977			
Terminating CCL Premium	Line 39 WP A-3	RTE-1 Ln 140 Col D	RTE-1 Ln 140 Col G		Line 7 WP B-3	RTE-1 Ln 140 Col C	RTE-1 Ln 140 Col F	
Terminating CCL Non Premium	45% of Terminating CCL Prem	RTE-1 Ln 150 Col D	RTE-1 Ln 150 Col G		45% of Terminating CCL Prem	RTE-1 Ln 150 Col C	RTE-1 Ln 150 Col F	
Originating CCL Premium	Line 39 WP A-3	RTE-1 Ln 160 Col D	RTE-1 Ln 160 Col G		Line 8 WP B-3	RTE-1 Ln 160 Col C	RTE-1 Ln 160 Col F	
Originating CCL Non Premium	45% of Originating CCL Prem	RTE-1 Ln 170 Col D	RTE-1 Ln 170 Col G		45% of Originating CCL Prem	RTE-1 Ln 170 Col C	RTE-1 Ln 170 Col F	
Traffic Sensitive	IND-1 Ln 150 Col A	IND-1 Ln 150 Col B	SUM-1 Ln 170 Col C		IND-1 Ln 160 Col I	IND-1 Ln 160 Col G	SUM-1 Ln 170 Col B	
Special Access	IND-1 Ln 280 Col A	IND-1 Ln 280 Col B	SUM-1 Ln 220 Col C		NA	NA	NA	
Trunking	NA	NA	NA		IND-1 Ln 520 Col I	IND-1 Ln 520 Col G	SUM-1 Ln 220 Col B	
Interexchange	IND-1 Ln 290 Col A	IND-1 Ln 290 Col B	SUM-1 Ln 230 Col C		IND-1 Ln 600 Col I	IND-1 Ln 600 Col G	SUM-1 Ln 230 Col B	

Impact of Bell Atlantic Including 1991 and 1992 OPEB Exogenous Costs In its 1993 Annual Filing *

	(A) Line Description	(B) Common Line	(C) Traffic Sensitive	(D) Specials	(E) = (B+C+D) **Total**	(F) Interexchange
Line 1	Below Cap $	$18,242,814	$25,731,223	$152,195	**$44,126,232**	$1,798,425
Line 2	1991 and 1992 OPEB Exog Cost	$15,384,020	$15,008,800	$5,628,300	**$36,021,120**	$1,500,880
Line 3 (the greater of $0 or Ln2-Ln1)	OPEB Exogenous Cost Refund	$0	$0	$5,476,105	**$5,476,105**	$0

* Bell Atlantic 1993 Annual Filing Transmittal No. 579, filed 6/29/93, effective 7/1/93.

Impact of Bell Atlantic Including 1991 and 1992 OPEB Exogenous Costs In its 1994 Annual Filing *

	(A) Line Description	(B) Common Line	(C) Traffic Sensitive	(D) Trunking	(E) = (B+C+D) **Total**	(F) Interexchange
Line 1	Below Cap $	$0	$55,632	$11,554	**$67,186**	$1,210,031
Line 2	1991 and 1992 OPEB Exog Cost	$883,140	$861,600	$323,100	**$2,067,840**	$86,160
Line 3 (the greater of $0 or Ln2-Ln1)	OPEB Exogenous Cost Refund	$883,140	$805,968	$311,546	**$2,000,654**	$0

* Bell Atlantic 1994 Annual Filing Transmittal No. 673, filed 6/29/94, effective 7/1/94.