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May 13, 2004

VIA ELECTRONIC SUBMISSION

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW – Lobby Level
Washington, D.C. 20036

Re: ***Notice of Ex Parte – CC Docket Nos. 93-193, 94-65, and 94-157***
Verizon Telephone Companies Petition for Reconsideration,
"In the Matter of Stale or Moot Docketed Proceedings"

Dear Ms. Dortch:

On May 12, 2004, Scott Anstretch of Kellogg, Huber, Hansen, Todd, and Evans, P.L.L.C., James C. Smith and the undersigned, on behalf of SBC Telecommunications, met with John Rogovin, Linda Kinney, John Stanley, Debra Weiner, Laurel R. Bergold, and Jane Jackson of the Office of General Counsel to discuss the above referenced proceedings. During the course of the meeting, we reiterated SBC's legal positions as it reflected in its previous filings. SBC utilized the attached document as the basis for discussion.

Pursuant to 1.1206 of the Commission's Rules, this letter is being filed electronically with the Commission.

Sincerely,

/s/ Gary L. Phillips

Attachment

cc *(via electronic mail)*:
John Rogovin
Linda Kinney
John Stanley
Debra Weiner
Laurel Bergold
Jane Jackson
Scott Anstretch

OPEBS

I. THE ISSUE

This proceeding relates to 1996 LEC tariff filings. Specifically, it raises the issue of whether LECs were required at the time to reduce their rate bases by the amount of OPEB liability they recorded on their books.

As I show below, the answer is clear from the Commission's own decisions. Section 65.800 of the Commission's rules stated (and still states) *the rate base shall consist of* the accounts in § 65.820 "minus deductions "computed in accordance with § 65.830." In other words, LECs were *directed* to take the accounts in 65.820 and make the deductions provided for in 65.830.

This investigation, therefore, is solely about the meaning of § 65.830 – which is why that is, in fact, the *only* issue teed up in the *Suspension Order*. That order announced an investigation of what the existing rules required. It did not raise any other issue – and specifically, it did not raise the issue of whether the Commission could retroactively change its rules in this eight-year old investigation.

The Commission has already addressed the scope of 65.830. In fact, it has done so twice, and the Commission's holding in those cases is dispositive. It held that § 65.830 did not require that accrued OPEB liabilities be deducted from the rate base.

II. BACKGROUND

A. SFAS-106 (December 1990)

- Established new accounting and reporting requirements for "other post-retirement employee benefits" (OPEBs). Prior to SFAS-106, most companies had recognized OPEB expenses when they were paid. SFAS-106 required companies to treat OPEB costs as expenses during the years the benefits are earned and to record a liability for benefit amounts owed to employees.

B. RAO 20 (May 1992)

- Based solely on a finding that "postretirement benefits are similar to pension expenses recorded in Accounts 4310 and 1410, and as such should be given the same rate base treatment," the Bureau held that "the interstate portion of the unfunded accrued postretirement benefits recorded in Account 4310 should be deducted from the rate base."

C. Rescission Order (March 1996)

- FCC found that the Bureau exceeded its delegated authority in ordering LECs to reduce their rate bases by the amount of OPEB liability recorded in Account 4310.

    - "Sections 65.820 and 65.830 of our rules "***define explicitly*** those items to be included in, or excluded from, the interstate rate base. The Bureau cannot properly address any additional exclusions in an RAO letter[.]"

    - Reiterating that its rules *mandated* the rate base treatment of OPEB costs, it noted: "The rate base rules, codified at 47 CFR §§65.800-.830, list the Part 32 accounts that <u>*are to be*</u> included in and excluded from the rate base that telephone companies use to calculate their interstate costs." (n. 3, emphasis added).

- FCC issued NPRM proposing a change in its rules to require that OPEB costs be deducted from the rate base.

    - The NPRM compared OPEBs to pensions and stated that – as was the case with pensions -- the rate base (which are the assets on which a return is permitted) should not include ratepayer-supplied funds: "Our proposal to modify our rate base rules ... is motivated by our continuing concern that zero-cost sources of funds, those funds provided to a carrier without cost to investors, be removed from the rate base. We believe that this proposal properly recognizes that ratepayers should only pay a return on those amounts that the carrier has prudently invested in used and useful plant. ...Where carriers have accrued OPEB costs, but have not paid their OPEB liability, the recovered but unpaid costs are capital available to the carrier at no cost. Consequently, the accrued OPEB liability recorded in Account 4310 should be removed from the rate base as a zero-cost source of funds."

F. <u>1996 Tariffs and Investigation Order</u>

- Between RAO 20 in 1992 and *Rescission Order* in 1996, LECs had reduced their rate base by the amount of accrued OPEB liability they recognized on their books.

- These rate base reductions had the effect of increasing the LECs' rates of return during that period. Those increased rates of return, in some cases, resulted in increased sharing obligations.

- In their 1996 tariffs, the LECs adjusted their PCI to correct for the excessive sharing that resulted from their adherence to RAO 20 in 1992-1995.

- The Bureau suspended these tariffs for one day and initiated an investigation. The Bureau stated the issue as follows: "[O]ne possible construction of our rules is that all costs, including OPEB costs, not specifically excluded should be included

in the interstate rate base. On the other hand, it would be possible to interpret our rules to permit a case-by-case evaluation of the correct rate base treatment of costs not explicitly identified in Part 65. Under this interpretation, the Commission could determine, for example, that OPEB costs should be accorded a particular rate base treatment based on an analogy to other costs. Accordingly, we conclude that the LECs' rate base treatment of OPEBs raises a substantial question of lawfulness under existing rules that warrants investigation." (¶ 20)

G. 1997 Report and Order

- FCC amended its rules to require LECs to reduce their rate base by the amount of accrued OPEB liability they have recognized on their books. It held "because the amounts recorded in Account 4310 are zero-cost sources of funds, rates should not provide a return on those amounts."
  - In so holding, the FCC rejected the LEC argument that OPEB amounts are not ratepayer-supplied funds because they were not factored into pre-price cap rates. The only explanation it gave is one sentence: "To the extent carriers are earning a positive return on assets funded in part by [accrued OPEB liabilities] these carriers are recovering their OPEB costs." (¶ 17)

- FCC also rejected MCI's Petition for Reconsideration of the *Rescission Order.*
  - MCI had raised the very issue the Bureau posited in the *Investigation Order*. It claimed that the FCC has "broad discretion in interpreting [its] rules and that a rule change is not needed to determine the rate base treatment of OPEB." It argued that "because the rate base treatment of pensions was already established, and because pensions are similar to OPEB, [the Commission] can apply the pension rate base rules to OPEB through an interpretation."
  - The FCC rejected MCI's argument, holding that the Bureau did not have delegated authority to require rate base changes based on OPEB expense. It held that"[g]iving rate base recognition to OPEB in Part 65 would constitute a rule change for which proper notice and comment must be given."

II. LECs WERE NOT ONLY NOT REQUIRED TO DEDUCT OPEB LIABILTIES FROM THEIR RATE BASES; THEY WERE NOT *ALLOWED* TO.

- Section 65.800 of the Commission's rules states: "The rate base shall consist of the interstate portion of the accounts listed in § 65.820 that has been invested in plant used and useful in the efficient provision of interstate telecommunications services regulated by this Commission, minus any deducted items computed in accordance with § 65.830.

- This rule gives clear and explicit direction on how LECs are to calculate their rate bases.

It ***requires*** LECs to calculate their rate base with reference to the Commission's ***rules*** – specifically §§ 65.820 and 65.830 of those rules.

- That is why both the *Rescission Order* and the *Order on Reconsideration* note that the Commission's *rules* specify what should and should not be in the rate base:

  - *Rescission Order:* "Sections 65.820 and 65.830 of our rules "***define explicitly*** those items to be included in, or excluded from, the interstate rate base.

  - *Both* orders state: "The rate base rules, codified at 47 CFR §§65.800-.830, list the Part 32 accounts that *are to be* included in and excluded from the rate base that telephone companies use to calculate their interstate costs." (*Rescission Order, n. 3, Recon Order, n. 16* (emphasis added))

- Thus the *sole* issue in this proceeding is what the Commission's Part 65 rules required with respect to OPEBs at the time.

- That is, in fact, the very issue raised in the *Suspension Order.* That order initiates an investigation of LECs' rate base treatment of OPEBs "under existing rules." (¶ 19) It in no way goes beyond existing rules because any such inquiry would be irrelevant, given § 65.800 of the Commission's rules.

- Both the *Rescission Order* and the *Order on Reconsideration* make clear that LECs were not required to deduct accrued OPEB liabilities under the Commission's rules at the time. The Commission held in both orders that § 65.830 did not include accrued OPEB liabilities among the items to be deducted from the rate base, and it squarely rejected arguments that the Commission could somehow *interpret* § 65.830 as encompassing accrued OPEB liability by analogizing OPEBs to pensions.

  - That is why the Commission issued an NPRM with the *Rescission Order* in order to *change* § 65.830 of the rules.

- Section 65.800 of the Commission's rules is thus dispositive. In fact, if a LEC had deducted an item, such as accrued OPEB liability, that was not encompassed within § 65.830 of the Commission's rules, it would have violated 65.800.

- Even AT&T conceded after the Rescission Order, in its comments on the NPRM issued with that order, that "any change to the [rate base] rules will affect the rate base on a prospective basis and will not affect the pending OPEB investigations because those investigations deal with past OPEB costs." (*Order on Reconsideration* ¶ 22)

- The FCC may not find that, notwithstanding its rules, the "just and reasonable "standard itself compelled the deduction of OPEB liabilities from the rate base. Indeed, AT&T does not even so argue, and for good reason:

- This is not a case in which the Commission's rules were silent with respect to the issue. (*see above)* In fact, as noted, any deduction of liabilities not covered by § 65.830 of the Commission's rules would have violated § 65.600.

- AT&T's argument that tariff investigations are rulemaking proceedings in which the rules can be changed retroactively is frivolous.

  - The FCC cannot change its rules retroactively in an investigation. Rather, the courts have made it clear that the Commission is required to follow its own rules until such time as it alters them through another rulemaking.

  - In fact, the FCC was reversed by the D.C. Circuit when it deviated from its exogenous cost rules in a tariff investigation involving OPEBs. *Southwestern Bell v. FCC,* 28 F.3d 165, 169 (D.C. Cir. 1994) ("[b]oth sides agree that the FCC's statement of its criteria for exogenous cost treatment constituted a rule, not a policy statement. ... Accordingly, the Commission was bound to follow those statements until such time as it altered them through another rulemaking.")

    - AT&T tries to distinguish the *Southwestern Bell* case by claiming that the Commission did not assert its rulemaking authority in the tariff investigation but, rather found only that its existing rules could be interpreted to preclude the exogenous adjustment at issue. But that argument is unavailing because the *Investigation Order* here likewise is limited to the issue of what *existing rules* require: "Accordingly, we conclude that the LECs' rate base treatment of OPEBs raises a substantial question of lawfulness under existing rules that warrants investigation." (¶ 19)

- Equally unavailing is AT&T's argument that the adjustments to the 1996 tariff constituted impermissible exogenous cost changes.

  - The adjustments were not exogenous cost changes. They were adjustments to the PCI to correct for the past errors in calculating the rate of return as required by RAO 20.

- Also wrong is AT&T's third and final argument - that Rule 65.600(d) prohibits LECs from restating their earnings more than 15 months after the end of a calendar year.

  - In fact, the rule does not so provide. It requires that within 15 months of the end of each calendar year, LECs "file a report reflecting any corrections or modifications to their interstate rate of return," but it does not say that a further restatement is not permitted.

- Indeed, it would be confiscatory for the FCC to adopt such a rule for cases like this, where the Commission's four year delay in resolving the Applications for Review of RAO 20 made it impossible to make the necessary corrections in the 15-month report.

III. WHILE THE LAW IS CONTROLLING HERE, THE POLICY ARGUMENTS IN SUPPORT OF RATE BASE DEDUCTIONS ARE SPECIOUS.

- The Bureau's stated justification – and only justification -- for requiring rate base reductions in RAO 20 was its "opinion that postretirement benefits are similar to pension expenses recorded in Accounts 4310 and 1410 and as such should be given the same rate base treatment." But this was flawed reasoning.

- LECs began accounting for pension expense on an accrual basis in the mid-1980s – *while they still were subject to rate of return regulation.* Under rate of return regulation, LECs' were entitled to a revenue requirement consisting of their expenses plus a return on their rate base. Thus, LECs were able to recover from ratepayers all of their accrued pension expense. Because LECs did not actually have to pay this money to retirees at the time they recovered it from ratepayers, they could earn a return on it during the interim, as if it were an asset in their rate base. But under rate of return regulation, LECs were not entitled to earn a return on their expenses; they were permitted only to earn a return on their rate base. And so the Commission required LECs to reduce their rate base by the amount of accrued pension expense they recovered from ratepayers.

- When the Commission adopted price caps regulation for LECs the PCIs initially were set based on the revenue requirement under rate of return regulation. Thus the PCI reflected full recovery of accrued pension expense.

- Had LECs obtained exogenous treatment of accrued OPEB costs, such that those costs were recovered in full from ratepayers (like accrued pension costs were), rate base reductions would, in fact, have resulted in similar treatment for OPEBs and pension expense. But the FCC denied LEC requests for exogenous cost treatment of OPEBs.

    - While accrued OPEB expenses can indirectly affect LEC price cap rates by reducing sharing obligations, the maximum indirect recovery is one half of that expense, and that savings is not available until the year *after* the expense is booked (*i.e.,* the year the sharing obligation kicks in). Thus accrued OPEB expenses should not be treated like accrued pension expense, and prior Commission decisions that concluded otherwise – though irrelevant to this investigation -- were misconceived.