automatically to recoup misallocated non-regulated costs by raising basic service rates, thus reducing the incentive for the BOCs to shift non-regulated costs to regulated services."[65]

The Commission examined the continued need for its cost assignment rules in light of price cap regulation in 1996.[66] In that proceeding, the Commission found that carriers still had a potential incentive to "assign a disproportionate share of costs to regulated accounts" due to the sharing component of price caps, the lower formula adjustment mechanism ("LFAM"),[67] and the fact that some intrastate services remained under rate-of-return regulation. However, the Commission's findings are no longer applicable to BST.

First, in 1997 the Commission eliminated the sharing component (*i.e.*, the "sharing" of excess earnings with ratepayers) that was included in the original price cap plan. Elimination of the sharing requirement, the Commission observed, "[r]educed reliance on accounting costs," which, according to the Commission, would "facilitate[] our transition to the competitive paradigm of the 1996 Act."[68]

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[65] *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards*, CC Docket No. 90-623, *Report and Order*, 6 FCC Rcd 7571, 7596, ¶ 55 (1991), *vacated in part and remanded, California v. FCC,* 39 F.3d 919 (9th Cir. 1994), *cert denied*, 514 U.S. 1050 (1995); *see also, California v. FCC*, 39 F.3d at 926-27; *United States v. Western Elec. Co.*, 993 F.2d 1572, 1580 (D.C. Circuit), *cert denied,* 510 U.S. 984 (1993) ("[price cap regulation] reduces any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling").

[66] *Accounting Safeguards Order, supra,* 11 FCC Rcd 17539.

[67] The original price cap plan included a mechanism that protected carriers from earning below a prescribed rate of return. If the carrier could demonstrate that its earnings were below the rate of return set in the plan, the carrier could make a below cap filing to increase rates to achieve the prescribed rate. As discussed herein, the LFAM has been eliminated for BST.

[68] *See Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, CC Docket Nos. 94-1 and 96-262, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642, 16700, ¶ 152 (1997) ("*1997 Price Cap Review Order*"), *aff'd in part, rev'd in part, United States Telecom Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

Second, as a result of pricing flexibility,[69] the LFAM is no longer applicable to BST, which further erodes any need for retaining the cost assignment rules.[70] Indeed, in eliminating the LFAM for ILECs operating under pricing flexibility, the Commission found that doing so "might enable the Commission to relax, for that LEC, any accounting rules necessitated only by the rate-of-return-based low-end adjustment mechanism."[71]

Third, as discussed previously, BST operates under price regulation in all of its states. Thus, there are no longer any intrastate services offered by BST that remain under rate-of-return regulation, which further eviscerates the need for the Commission's cost assignment rules.

It has been argued in the past that, even with price cap carriers, the cost assignment rules continue to be important to the federal price cap process because they impact the productivity factor and exogenous cost elements used in the price cap formula.[72] This argument is without merit.

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[69] In the *Pricing Flexibility Order*, the Commission granted price cap carriers greater freedom in pricing certain services subject to the carrier demonstrating a sufficient level of competition within the market for those services. *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket Nos. 96-262, 94-1 & 98-157, CCB/CPD File No. 98-63, *Fifth Report and Order and Notice of Proposed Rulemaking*, 14 FCC Rcd 14221, 14251 n.144 (1999) ("*Pricing Flexibility Order*").

[70] The LFAM was eliminated for any price cap ILEC that chose to take advantage of pricing flexibility for access services, which all of the major ILECs have done. *See Pricing Flexibility Order*, 14 FCC Rcd at 14304, ¶162, ("We eliminate the low-end adjustment mechanism for price cap LECs that qualify for and elect to exercise either the Phase I or Phase II pricing flexibility we grant in this Order.").

[71] *Id.* at, 14306-07, ¶ 166.

[72] *See, e.g.*, Letter from Alan Buzacott, Senior Manager, Regulatory Affairs, MCI, to Michelle Carey, Chief, Competition Policy Division, Wireline Competition Bureau, FCC (Feb. 9, 2004), transmitted by letter from Gil M. Strober, Lawler, Metzger & Milkman, LLC, to Marlene Dortch, Secretary, FCC, WC Docket No. 02-112 & CC Docket No. 00-175 (Feb. 9, 2004) ("MCI Letter"); Letter from Michael J. Hunseder, Sidley Austin Brown & Wood, LLP, to

First, the productivity or "X-factor" "measure[s] . . . the amount by which LEC productivity exceeded that of the economy as a whole."[73] In the price cap formula, the productivity factor offset "subtracts the amount by which LECs can be expected to outperform economy-wide productivity gains."[74] This factor is established using a variety of methodologies based on economic inputs that look at the productivity of the domestic economy as a whole, as well as the telecommunications industry. None of these methodologies relies on the cost assignment rules.[75]

Second, by definition, exogenous costs are those "triggered by administrative, legislative, or judicial action *beyond the control of the carriers*."[76] Exogenous changes represent items that would have had an impact on the July 1, 1990 data used to establish the initial price cap rates, but were not reflected in the initial rates. Indeed, two exogenous adjustments noted in the price cap rules would be inapplicable if BST's Petition is granted. The first is cost changes caused by changes in the separations manual, and the other is cost changes caused by the reallocation of investment from regulated to nonregulated activities pursuant to 64.901. The separations manual adjustments were mooted by the implementation of the separations freeze in 2001. And, if BST were no longer required to apply 64.901, then the exogenous adjustment

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Marlene H. Dortch, Secretary, FCC, CC Docket No. 02-33 & WC Docket No. 02-112 (Feb. 13, 2004) ("AT&T Letter").

[73] *Price Cap Order*, 5 FCC Rcd at 6796, ¶ 74.

[74] *Id.*

[75] Although economic inputs may include total company costs, those costs are not derived from, or based on, the cost assignment rules. In any event, such total company cost information will remain readily available, should it be needed for valid regulatory purposes.

[76] *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, *Order on Reconsideration*, 6 FCC Rcd 2637, 2662, ¶ 58 (1991).

relating to the reallocation of investments from regulated to nonregulated activities would also be rendered moot.

2. <u>The States[77] do not rely on cost assignment data to set BST's rates.</u>

At the state level, BST's rates are regulated under price cap plans without regard to the information generated by the Commission's cost assignment rules. Indeed, if the Commission were to grant BST's Petition, the state commissions in BST's region would continue to regulate BST's rates in the same way they have for the past decade.[78]

When a need exists for jurisdictional information for monitoring or other purposes, BST can develop such information to meet those state-specific requirements without continued compliance with the Commission's cost assignment rules. For example, in BST state jurisdictions, intrastate revenues must be identified for the purpose of assessing regulatory fees. BST's Petition does not affect revenue. Revenue can be identified by jurisdiction through the Part 32 accounts, and this Petition does not affect those accounts. The Petition deals only with the assignment of costs (expense and investment). Thus, the Commission's granting of this Petition would not impact BST's ability to provide revenue figures on an interstate or intrastate basis. Although ARMIS reports would only contain total revenues, BST's accounting records contain sufficient detail to enable BST to provide intrastate revenue data to any state public service commission in its territory as needed.

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[77] By including an analysis of state needs and requirements in this discussion, BST does not intend to suggest an expanded view of the Commission's jurisdiction. Indeed, BST assumes that the Commission, as it stated in the *Phase 2 Order and NPRM*, continues to "*believe that, if we cannot identify a federal need for a regulation, we are not justified in maintaining such a requirement at the federal level.*" *Phase 2 Order and NPRM, supra*, 16 FCC Rcd 19,911 at ¶ 207 (emphasis added).

[78] *See* discussion in footnote 45, *supra*, and Appendix 2.

Similarly, all of the states in BST's region require that the price for a new service equal or exceed the long run incremental cost ("LRIC") or the total service long-run incremental cost ("TSLRIC") of such service. However, this requirement has no bearing on the Commission's decision here because none of the cost assignment rules is necessary for the calculation of either LRIC or TSLRIC, both of which measure *forward-looking costs.* The *only* situation in which historical costs factor into a LRIC or TSLRIC calculation is with respect to indirect costs. However, indirect costs are generally determined based on ratios of direct costs, which can be calculated without having to apply the Commission's cost assignment rules.

In three states -- Kentucky, Louisiana, and Mississippi – BST submits income statement detail for regulated or intrastate operations. However, continued compliance with the Commission's cost assignment rules is not necessary for BST to meet these reporting requirements. Certainly, no "strong connection" exists between the cost assignment rules' continued application and these limited regulatory purposes. Rather, BST can provide state-specific data for Kentucky, Louisiana, and Mississippi by performing state-specific studies.[79]

Furthermore, it makes little sense to use federally mandated, region-wide cost data to satisfy state-specific reporting obligations, since such requirements could change. Indeed, since inception of price regulation, the states have steadily streamlined or eliminated financial reporting requirements to reflect the changing regulatory and competitive environment. Forbearance would facilitate BST's ability to meet the needs of individual states as they adopt reporting requirements that are more reflective of the price regulation plans now in place.

[79] To the extent that any of BST's states requires allocated or separated costs for regulatory purposes, BST can produce the data by performing targeted, state-specific studies to meet any such requirements.

In short, the Commission's cost assignment rules have outlived their usefulness. By regulating rates without regard to BST's costs, the current price cap regime at both the federal and state level has eliminated any incentive BST may have once had to misallocate or overstate its costs, which is the reason the cost assignment rules were adopted in the first place.

3. **<u>The Commission has recently recognized the disconnection of cost assignment-derived data from price cap rate-setting.</u>**

The Commission recently reached this conclusion in its *Wireline Broadband Order*, in which the Commission revisited the regulatory classification of broadband Internet access services offered by ILECs. Specifically, the Commission found ILEC broadband Internet access service to be an information service and concluded that ILECs

> are no longer required to separate out and offer the wireline broadband transmission component . . . of wireline broadband Internet access services as a stand-alone telecommunications service under Title II . . . . In addition, the Bell Operating Companies (BOCs) are immediately relieved of all other *Computer Inquiry* requirements with respect to wireline broadband Internet access services."[80]

In so doing the Commission additionally found that, while the wireline broadband Internet access is a nonregulated information service, *ILECs did not have to allocate any portion of the network costs to nonregulated activities* as would normally be required pursuant to Part 64. The Commission based this decision on the fact that *price cap ratemaking obviated the need for cost allocation* and further recognized the complexity and burden, with little corresponding benefit, that such allocation causes. As the Commission stated:

> Requiring that incumbent LECs classify the provision of broadband Internet access transmission provided on a non-common carrier basis as a nonregulated activity under part 64 would mean, among other matters, that incumbent LECs would have to develop, and we would have to review, methods for measuring the relative usage that this transmission and the incumbent LECs' traditional local services make of incumbent LECs' transmission facilities. *Incumbent LECs*

[80] *Wireline Broadband Order,* ¶ 5.

argue that they should not have to undertake this task because it would impose significant burdens on them with little discernible benefit. We agree.[81]

The Commission further acknowledged that price cap regulation all but eliminated the need for cost allocation, especially in the light of the burdens it requires:

> During the period since the adoption of the part 64 cost allocation rules, our ratemaking methods and those of our state counterparts have evolved considerably. This evolution has greatly reduced incumbent LECs' incentives to overstate the costs of their tariffed telecommunications services. *Based on the current record, we find that this reduction in incentives diminishes the need for incumbent LECs to apply detailed and burdensome procedures to exclude the costs of providing broadband Internet access transmission from their regulated costs. A nonregulated classification therefore would generate at most marginal benefits.*
>
> *Requiring that incumbent LECs classify their non-common carrier, broadband Internet access transmission activities as nonregulated activities under part 64 would impose significant burdens that outweigh these potential benefits.*[82]

The salient regulatory principle that the Commission embraced in the broadband Internet access services context applies equally to all services provided by price cap regulated carriers such as BST. As the Commission concluded, the cost assignment rules provide no real benefit when price caps are in place, since they are not necessary to determine whether rates are just and reasonable – a conclusion that does not and should not depend on the service being provided.[83]

B. <u>The Cost Assignment Rules Are Unnecessary To Protect Consumers.</u>

There is no consumer, or general public interest protected or advanced by virtue of BST's continued compliance with the Commission's cost assignment rules. Although various theories

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[81] *Id.* ¶ 131 (emphasis added).

[82] *Id.* ¶ 133-34 (emphasis added).

[83] Furthermore, given the operational burdens imposed by the cost assignment rules – burdens that go well beyond accounting for wireline broadband Internet access service – the Commission should forbear from requiring continued compliance with such rules.

have been advanced over the years in an attempt to justify the continued application of those rules, none has merit in a situation where a carrier is subject to price cap regulation.

1. <u>The cost assignment rules are not necessary for the fulfillment of the Commission's Universal Service obligations.</u>

It has been argued that the Commission's cost assignment rules are needed for the calculation of universal service support governed by Section 254 of the 1996 Act.[84] This argument is misguided.[85]

Section 254(k) prohibits a carrier from using services that are not competitive to subsidize services that are competitive. Additionally, it requires the Commission, through the establishment of any *necessary* cost allocation rules, accounting safeguards, and guidelines, to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.[86] The rules from which BST seeks forbearance do nothing to ensure that the objectives of Section 254(k) are met.

As discussed extensively above, no matter what constitutes BST's "regulated" costs, BST's prices are regulated by price caps that do not take those costs into account. Price caps, in fact, were implemented to ensure that a carrier could not increase prices for services subject to price caps to offset prices for services not subject to those caps. As such, in adopting price cap regulation, the Commission has already satisfied its obligations under Section 254.

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[84] 47 U.S.C. § 254; *see 2000 Biennial Regulatory Review, supra*, at ¶ 11.

[85] *See Wireline Broadband Order*, ¶ 139 ("[The Commission's] actions [eliminating allocation of cost to non-regulated for broadband Internet access services,] in this Order . . . do not create a violation of section 254(k)").

[86] The Commission codified this section in Part 64: "A telecommunications carrier may not use services that are not competitive to subsidize services subject to competition. Services included in the definition of universal service shall bear no more than a reasonable share of the joint and common costs of facilities used to provide those services." 47 C.F.R. § 64.901(c).

Moreover, the Commission's current mechanism for determining fund contributions is based on *interstate end-user revenues, not carrier costs.*[87] As discussed, price cap carriers' prices – and resulting revenues – are also not regulated based on costs. Because a carrier's revenues are based on the prices charged to customers -- not on the assignment of costs under the Commission's rules -- forbearance from such rules will not affect USF contributions. Similarly, high cost distributions from the USF will not be impacted by forbearance as they are based on a *hypothetical* cost model -- not the kind of embedded carrier cost structure contained in Parts 32 or 64. Accordingly, the cost assignment rules are simply not *necessary* in this context.

Finally, any allocation required under section 254(k) (even though it is no longer needed for universal service) is not limited to only ILECs but is applicable to all carriers. The Commission cannot and should not satisfy this obligation by continuing to apply rules that govern only a handful of carriers to which the vast majority of carriers competing in the marketplace are not subject.

2. The cost assignment rules do not guard against price squeezes.

Some have argued that, without the Commission's cost assignment rules, BST would be able to charge lower prices for competitive services by misallocating costs and thereby engage in an anticompetitive price squeeze.[88] This argument is wrong.

First, as the Commission recognized in the *Joint Cost Order*, the cost allocation and affiliate transaction rules were not implemented to protect against a price squeeze. Indeed, the Commission stated:

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[87] BST will continue to follow Part 32 revenue account classifications which separately identify intrastate and interstate revenue.

[88] *See generally* Recommendation by Joint Conference, WC Docket No. 02-269, at 23 (Oct. 9, 2003); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269, at 15-16 (filed Jan. 29, 2004).

> we disagree with those parties who intimate that we should design these rules so as to cause the accounting system to produce information that would allow us to determine whether prices for nonregulated products and services are anti-competitively low. *The pricing of individual nonregulated products and services does not fall within our statutory mandate*. Complaints about predatory pricing in nonregulated markets are the province of the antitrust laws. The proper purpose of our cost allocation rules is to make sure that all of the costs of nonregulated activities are removed from the rate base and allowable expenses for interstate regulated services. It is not our purpose, nor should it be our purpose, to seek to attribute costs to particular nonregulated activities for purposes of establishing a relationship between cost and price.[89]

Second, a price squeeze (*e.g.*, for a particular service) generally occurs when a "wholesale supplier, who also sells at retail, charges such high rates to its wholesale customers that they cannot compete with the supplier's retail rates."[90] A key issue in the price squeeze analysis is whether the relationship between wholesale and retail rates is responsible for the price squeeze.[91] The wholesale supplier's costs (*i.e.*, BST's costs) are irrelevant to this analysis.[92]

Third, a firm will engage in a price squeeze on the theory that it will be able to recoup profits lost in the short-term through the ability to charge monopoly profits after its competitors

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[89] *Joint Cost Order*, 2 FCC Rcd at 1304, ¶ 40 (emphasis added).

[90] *Joint Application by SBC Communications, Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a/ Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, CC Docket No. 00-217, Order on Remand, 18 FCC Rcd 24474, 24477 ¶ 7 (2003) (citing *Ellwood City v. FERC*, 731 F.2d at 959, n.15 (D.C. Cir. 1984) (internal citations omitted) ("*Kansas/Oklahoma Remand Order*").

[91] *Id.* (citing *InfoNXX, Inc. v. New York Tel. Co.*, 13 FCC Rcd 3589, 3600 ¶ 21 (1997)).

[92] *See, e.g., Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) And Verizon Global Networks Inc., for Authorization to Provide In-Region, InterLATA Services in Massachusetts*, CC Docket No. 01-9, *Order on Remand,* 19 FCC Rcd 2839, 2845, ¶ 14 (2004) (finding "materially insufficient" AT&T's and MCI's price squeeze allegations for Massachusetts, in part, because they failed to "provide cost or other data to support their assertions regarding their $ 10 internal cost of entry" and because their "assertions that they cannot achieve a sufficient profit margin in Massachusetts are undercut by the fact that both have entered the Massachusetts residential market ...").

have been driven from the market.[93] This "price squeeze" theory makes no sense in a market as competitive as the telecommunications market, as described in greater detail below.

Finally, the Communications Act's general provisions designed to guard against anticompetitive behavior are sufficient to protect against any alleged price squeezes. These provisions include the Commission's authority to suspend or reject tariffs prior to their taking effect and to take enforcement action against unlawful pricing, including, where appropriate, granting injunctive relief and awarding of damages to the complainant in a complaint proceeding. Such provisions do not require continued adherence to the Commission's cost assignment rules in order to function properly.[94]

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[93] Declaration of William E. Taylor, Timothy J. Tardiff, and Harold Ware, National Economic Research Associates, Inc., On Behalf of BellSouth, SBC, and Verizon, WC Docket No. 02-112, CC Docket Nos. 00-175, 01-337 & 02-33, at 14 (filed Aug. 10, 2004).

[94] *In re: Petition for Waiver of Pricing Flexibility Rules for Fast Packet Services; Petition for Forbearance Under 47 U.S.C. Section 160(c) from Pricing Flexibility Rules for Fast Packet Services*, Memorandum Opinion and Order, WC Docket No. 04-246 (Oct. 14, 2005), the Commission waived certain requirements under its price cap rules and regulations to allow Verizon to exercise pricing flexibility for advanced services that rely on packet technology similar to the pricing flexibility that it has for other special access services. In so doing, the Commission rejected AT&T's claim that the grant of a waiver could result in discriminatory pricing by Verizon that is anticompetitive and causes a "price squeeze." *Id.* According to the Commission, such "price squeeze" issues should be addressed in its *Special Access NPRM,* 20 FCC Rcd 1994, since such issues required extensive "marketplace data." Furthermore, the Commission noted that a price squeeze allegation "poses a fact-intensive, highly contentious allegation that turns on economic analysis," but which AT&T had offered "no significant data or analysis to support …." *Id.* The Commission's reasoning applies equally here; broad, unsupported allegations of purported price squeezes in the absence of the Commission's cost assignment rules do not give rise to a public interest finding sufficient to deny BST's Petition.

3. <u>The cost assignment rules are not necessary to determine rates for unbundled network elements.</u>

In past Commission proceedings, some parties have contended that the cost assignment rules should be maintained because they support some of the cost models used to determine the forward-looking costs of unbundled network elements.[95]

This contention is wholly unpersuasive because unbundled network element costs represent the *forward-looking economic cost* of a particular element of the telecommunications network -- not the embedded historical costs of that facility or the cost of different services that are provided utilizing those network elements. In this regard, the TELRIC methodology focuses on determining the forwarding-looking cost of providing an element of the network, such as an unbundled loop, to a competitive local exchange carrier ("CLEC"). By contrast, the purpose of the Commission's cost assignment rules is to address historical embedded costs and investment – a purpose fundamentally misaligned with the objective of unbundled network element cost studies.

Furthermore, even though current TELRIC cost models may utilize certain factor relationships developed from historical regulated results to anticipate similar cost relationships in calculating forward-looking cost, this does not mean that the Commission's cost assignment rules are necessary for TELRIC cost studies. One example of such a factor relationship is the specific expense for aerial metallic cable plant as it is relates to aerial metallic cable investment. Whereas Part 64 rules would look to the type of traffic usage that is transmitted over the cable in

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[95] *See, e .g.*, Comments of the National Association of State Utility Consumer Advocates ("NASUCA"), WC Docket No. 02-269, at 6 (filed Jan. 30, 2004); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269, at 6-7 (filed Jan. 29, 2004); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269, at 6 (filed Jan. 30, 2003); Comments of AT&T Corp., WC Docket No. 02-269, at 13-14 (filed Jan. 31, 2003).

order to allocate costs between regulated and nonregulated services, the information that is desired for TELRIC purposes is how much plant specific-type expense is required – on a forward-looking basis -- to maintain aerial metallic cable *regardless of the type of traffic usage on the cable.*

4. The cost assignment rules are not necessary to allow regulators to perform their monitoring and oversight responsibilities.

In the Joint Conference proceeding, several state public service commissions argued that, even with price cap regulation, regulators continue to need regulatory accounting and reporting in order to monitor carriers and perform oversight responsibilities.[96] This argument, even assuming it were correct, does not impact the merits of this Petition because BST is not seeking forbearance from any of the Commission's rules regarding Part 32 *accounts* identified as a key state commission concern. If BST's Petition is granted, the Part 32 accounts will remain intact and all relevant ARMIS reports will continue to be produced.

The concerns voiced in the Joint Conference proceeding mainly focused on the Part 32 accounts and whether some accounts, which the Commission had eliminated in its *Phase 2 Order*, should be reinstated and whether some new accounts should be created. The Joint Conference issued a recommendation to the Commission, which addressed these issues specifically. For example, in the *Joint Conference Order*,[97] the Commission decided, based

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[96] *See, e.g.*, Comments of the North Carolina Utilities Commission – Public Staff, WC Docket No. 02-269 (filed Jan. 31, 2003); Comments of the Florida Public Service Commission Regarding Accounting Issues, WC Docket No. 02-269 (filed Jan. 29, 2003); Comments of the Public Service Commission of Wisconsin, WC Docket No. 02-269 (filed Jan. 30, 2003).

[97] *Federal-State Joint Conference on Accounting Issues; 2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*, WC Docket No. 02-269; CC Docket Nos. 00-199, 80-286 & 99-301, *Report and Order*, 19 FCC Rcd 11732 (2004).

upon the recommendation of the Joint Conference, to reinstate several accounts it had previously consolidated.[98] Nothing in BST's Petition would affect those accounts; they would remain in Part 32, and BST would continue to record those accounts as it does today.

The Joint Conference Report also made recommendations regarding affiliate transactions, claiming that continued monitoring of such transactions was necessary in order to deter "anticompetitive manipulation of costs, revenues, and earnings."[99] It went on to refer to the need to avoid "accounting scandals," such as those involving Enron and WorldCom.

However, the accounting scandals addressed in the Joint Conference are not in any way related to the Commission's affiliate transaction rules. The affiliate transaction rules were put in place to prevent cross-subsidization of nonregulated services by regulated services under rate-of-return regulation. These rules have nothing to do with, and cannot ensure the financial integrity of, a publicly traded company, nor do they address the type of fraud and abuse in which both Enron and WorldCom routinely engaged (which, as discussed herein, has been addressed by Sarbanes-Oxley, among other things).

Furthermore, the "evil" that the affiliate transaction rules were put in place to guard against – cross-subsidization between regulated and nonregulated services -- is no longer a valid concern. Under price cap regulation, the allocation of costs associated with affiliate transactions has no bearing on the regulation of rates. For tariff filings involving price changes of existing services under price cap regulation, the ILEC must provide (as a part of its tariff filing) a

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[98] The *Phase 2 Order* consolidated account number 5230, directory assistance, into account number 5200, miscellaneous. It also consolidated account numbers 6621, call completion services, 6622, number services, and 6623, customer services into a single account – account number 6620. Finally, it consolidated four depreciation and amortization expense accounts, account numbers 6561, 6562, 6563, 6565 into one single depreciation and amortization expense account – account number 6560.

[99] *Id.*

demonstration that the price change is within the applicable price cap basket service band index limits and that the basket price cap index remains below the applicable basket actual price index after the price change.

Affiliate transactions are recorded on the books of the regulated telephone company in a multitude of accounts. These accounts, however, are never incorporated directly or indirectly into the formulas used to govern rates under price cap regulation. A change in the value of affiliate transactions recorded in the cost accounts will not, and cannot, have an impact on the prices resulting from the application of the price cap rules to existing services. In addition, the price cap baskets were originally designed to group similar or like services together, while at the same time preventing service prices in one particular basket from subsidizing the (lower) prices in another price cap basket. Thus, neither the Commission's affiliate transaction rules nor its other cost assignment rules are necessary to protect consumers and, thus, cannot be shown to be "strongly connected" to that goal.

C. Forbearance From The Commission's Cost Assignment Rules Is Consistent With The Public Interest.

1. The rules represent antiquated regulatory barriers that now must be broken down.

The rules at issue are not strongly connected – or connected at all – to rates. They are not strongly connected – or connected at all – to the consumer protection goals for which they were designed. The only possible remaining claim for their continued viability in BST's case is if, somehow, the rules add value to the products and services that today's consumers demand. They most assuredly do not.

Consumers in every market segment want the widest range, and broadest integration, of communications and information services that can be delivered.

Technological advancements make it possible to serve these demands. As the Commission itself observed:

> Reflecting these advances, manufacturers have developed powerful platforms that integrate traditionally separate computing and communications functions. * * * The technology used to build networks, and the purposes for which they are built, are fundamentally changing, and will likely continue to do so for the foreseeable future. . . . Network platforms therefore will be multi-purpose in nature and more application-based, rather than existing for a single, unitary technologically specific purpose.[100]

The cost assignment rules were developed and implemented in a technological era in which networks *did* exist "for a single, unitary technologically-specific purpose." Phone networks provided phone service. Computer networks provided computing service. The "twain did not meet." Now they do, and the range of possibilities is staggering. Rate-of-return era cost assignment rules could not be more ill-suited to the complex, integrated, network platforms that power the integrated products and services that BST provides, and that its customers demand. If it had it to do today, the Commission, one must assume, certainly would not re-create the rules in present form.

Complying with the rules presents a stiff (and undue) challenge to BST in today's integrated communications and information marketplace. The complexity of the allocations and separations decisions that the assignment rules compel has grown weed-like in the development and delivery of the products and services that consumers want. As shown in the IDSU (network asset) and advertising discussions above, the rules present time-consuming, resource-intensive "chokepoints" that slow the process of getting innovative, integrated services to customers. Customers do not want to wait --

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[100] *Wireline Broadband Order, supra,* at ¶¶ 35-41.

and, indeed, often cannot afford to wait – for BST to determine how to allocate costs associated with services and products.

When customers cannot get what they need in a time frame that competitive market conditions warrant, they have two choices: go elsewhere, or do without. Neither outcome serves the public interest. First, customers should not have to wait for compliance with rules-driven activity *that no longer has any bearing on the rates it charges customers and no longer serves any of the consumer protection ends originally contemplated.* Customers are served by having a variety of high-quality choices for their communications and information needs. Limiting BST's capacity to present such a choice to customers diminishes customers' prospects for no valid reason.

Second, if the customer has to forego the product or service, or has to settle for something with less functionality than BST could have provided if it had been able to deliver in timely fashion, everyone loses. Customers use BST's products and services, often enough, to enhance their own abilities to compete in the markets in which they operate, or the environments in which they live. Government customers administer to citizens based on services provided by BST. Students are educated to compete in today's global marketplace using BST's services and products. Businesses employ services and products provided by BST to enhance their domestic, and international, competitiveness. The list goes on and on.

Common to all of these consumer endeavors is the need for constantly evolving, integrated services and products -- and *fast*. BST embraces the challenge of meeting the scope of its customers' demands. But, BST must be allowed *to meet the pace of those demands as well.* Compliance with the cost assignment rules unquestionably slows BST down and, as demonstrated, there is simply no justification for it. It is certainly "consistent with the public interest," thus, for the Commission to "break down" the "rigid regulatory barriers" that the rules present to BST's ability dynamically to serve its customers.

2. <u>Granting the Petition is in the public interest because BellSouth will remain subject to all financial accounting requirements applicable to public companies.</u>

Granting BST's Petition will not result in a lessening of necessary protections for consumers or the public at large. To the contrary, BellSouth is, and will remain, subject to and governed by all financial accounting requirements applicable to publicly traded companies. BellSouth, like all other public companies, is subject to the jurisdiction and regulations of the Securities and Exchange Commission ("SEC"). As such, it must maintain books and accounts and prepare financial reports that conform to Generally Accepted Accounting Principles ("GAAP"), which are the accounting standards employed by publicly traded companies to determine and report their financial condition to the public. This information must be audited by an independent public accounting firm and publicly disclosed.

BST understands that, in the wake of recent high-profile accounting scandals involving large, publicly-traded companies such as Enron and WorldCom, the Commission may be concerned about a perceived lessening of accounting obligations for a carrier under its jurisdiction. BST does not take those concerns lightly. However, the Commission should be assured that this Petition does not involve or even impact any accounting rule or regulation, whether established by this Commission or any other regulatory authority, that is designed to protect the public from corporate malfeasance and to ensure accurate reporting of a company's financial health.

This Petition, if granted, would not eliminate any accounting requirement or regulation established by, or within the jurisdiction of, the SEC or any other agency regarding the proper recording of revenues, expenses, investment, or debt in financial statements. To demonstrate the types of controls under which BellSouth will remain if BST's Petition is granted, the independent accounting firm of Deloitte & Touche ("D&T") prepared a detailed analysis of the financial accounting and reporting rules and disclosures applicable to all public companies, such as BellSouth.[101] This analysis should give the Commission comfort that this Petition, if granted, will not diminish public protection.

As D&T discusses, public companies like BellSouth are subject to many layers of financial oversight through federal and state regulations and statutes. BellSouth is and will remain subject to the jurisdiction of the SEC, an agency that was created to "protect investors and maintain the integrity of the securities market."[102] The federal laws that the SEC administers "seek to ensure that the securities markets are fair and honest."[103] It ensures compliance through extensive periodic reporting requirements, which include an annual Form 10-K and three quarterly reports through Form 10-Q. These reports include financial information that is governed by Regulation S-X and non-financial information governed by Regulation S-K. The financial statements included in the reports filed with the SEC are required to have annual audits and interim reviews performed by independent auditors.[104]

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[101] Donna Epps, Deloitte & Touche LLP, *Reporting after Reform: Financial Accounting Rules and Disclosures in Reporting by U.S. Public Companies* (2005) ("D&T Paper") (attached as Appendix 8.

[102] *Id.* at page 19, Appendix A: SEC.

[103] *Id.*

[104] *Id.* at page 15.

In addition to the reporting requirements, the SEC has oversight responsibilities through monitoring and enforcement. Monitoring includes review of the Forms 10-K and 10-Q at least once every three years.[105] The SEC's enforcement division has civil as well as criminal authority over violations of any securities laws. Such violations include, but are not limited to, misrepresentation or omissions of important information from filed documents, and the mis-use of non-public information.[106]

Recent federal law developments have enhanced the SEC's (and other agencies') pre-existing regulatory, oversight and enforcement authority. The result of these developments is even greater protection to the public and investors from accounting abuses. The most significant of these new laws is the Sarbanes-Oxley Act, a major corporate accountability reform measure that imposes significant new disclosure requirements on all public companies.[107] Specifically, Sarbanes-Oxley makes a company's officers personally responsible for the company's financial statements and strengthens the audit requirements by expanding the scope of work that an auditor must perform in order to provide an unqualified opinion regarding a company's financial statements. Sarbanes-Oxley also created the Public Company Accounting Oversight Board ("PCAOB") "to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports for companies the securities of which are sold to, by and for, public investors."[108]

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[105] *Id.* at page 16.

[106] *See* D&T Paper at 17.

[107] *Id.* at 5.

[108] *Id.* at page 25, Appendix C: PCAOB. (The PCAOB must "conduct regular inspections of each firm to ensure that the firm and its professional practitioners are in

The PCAOB has enforcement authority over independent auditors of public companies and may impose appropriate sanctions[109] on any auditor that is found to violate "any provision of the Sarbanes-Oxley Act, any professional standards, any rules of the PCAOB or the SEC, or any provisions of the U.S. securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto."[110] Thus, Sarbanes Oxley not only places important new controls over the public companies themselves, it also created a regulatory body to oversee the auditors that audit these companies to ensure that they maintain independence from the companies and follow appropriate professional standards.

Sarbanes-Oxley also places significant new requirements for management and independent auditors to access, document and report on the effectiveness of Internal Control over Financial Reporting ("ICFR")."[111] This change includes "new reports and certifications by management on the effectiveness of the company's ICFR." [112] The auditor also must supplement its report on a company's financial statements with management's assessment on ICFR and on the effectiveness of the company's ICFR. This strengthening of internal control not only deters fraud but also prevents inaccurate financial statements.[113] BellSouth's most recent financial statement audit included over 2,000 hours of audit work that specifically tested for Sarbanes-Oxley compliance.

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compliance with the Sarbanes-Oxley Act, PCAOB rules and standards, SEC rules and standards, as well as professional standards [*e.g.*, AICPA's]").

[109] Sanctions "may range from monetary penalties and remedial measures, such as training, new quality control procedures, or the appointment of an independent monitor, to barring the firm or individual from future audits of public companies." D&T Paper at 18.

[110] D&T Paper at 18.

[111] *Id.* at 5.

[112] *Id.*

[113] *Id.*

In past proceedings, some commenters have argued that the Commission's accounting rules should remain in place to protect against the kind of behavior seen in past accounting scandals. The Commission, of course, is not a financial regulator, and its cost assignment rules were not established to and do not protect against the kinds of abuses seen in the high-profile accounting scandals of the late 1990s. In any event, Sarbanes-Oxley amply meets the concerns that various commenters have expressed before the Commission, and should remove any reservations the Commission might otherwise have had on the subject as it considers the merits of this Petition.

The GAAP-based accounting and reporting requirements established by various federal agencies, as well as the accounting standards established under the authority of the SEC, will be unaffected by the granting of BST's Petition. The SEC relies on the FASB to establish GAAP in the United States ("U.S. GAAP") through a prescribed standard-setting process. Financial statements filed with the SEC that are not in conformity with U.S. GAAP are considered to be misleading or inaccurate, and are therefore unacceptable to the SEC.[114] GAAP establishes that a company must disclose, both in notes to its financial statements as well as in the statements themselves, exactly how it applies accounting standards.[115]

BellSouth complies with GAAP for all financial accounting reporting purposes. The Commission accepts GAAP as an appropriate means of maintaining regulatory books and the

[114] *Id.* at 3. ("The SEC is legally charged with establishing accounting policies in the United States, but relies on private the standards –setting bodies such as the Financial Accounting Standards Board ("FASB"), [the PCAOB] and the American Institute of Certified Public Accountants ("AICPA").")

[115] D&T Paper at 7.

USOA currently prescribed by the Commission is primarily based on GAAP.[116] The Commission also has ordered ILECs' regulated separate affiliates to use GAAP.[117] CLECs, cable companies, wireless carriers, and others use GAAP for all accounting and financial reporting purposes.

BellSouth is also subject to the Foreign Corrupt Practices Act ("FCPA").[118] The FCPA, among other things, requires every public company to make and keep "books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."[119] The FCPA substantially penalizes "issuers" (*i.e.*, public companies) for failing to devise and maintain proper internal controls, or for making false entries in its financial books and records.

The Sarbanes-Oxley-augmented accounting and reporting oversight provided by the various accounting regulatory agencies ensures that BellSouth's investors and potential investors receive full and accurate information about all of BellSouth's financial dealings. The rules from which BST seeks forbearance have no impact on the accounting and disclosure rules and reporting requirements that are in place to protect the investment community. Any concern that eliminating cost assignment rules will weaken accounting regulatory oversight and enforcement is an unwarranted distraction from the central issue here, which is whether the cost assignment remain necessary for the purposes for which they were developed (which is not the case)..

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[116] Because BST is required to maintain accounting records under Part 32, the ILEC's financial results are close to, but not exactly the same as, the financial results under GAAP (*e.g.*, depreciation expense is treated differently.)

[117] *Accounting Safeguards Order, supra,* 11 FCC Rcd at 17618 and 17649, ¶¶ 170, 243.

[118] 15 U.S.C. §§ 78m (b) (2), 78dd-1, 78dd-2.

[119] *Id.* at § 78m(b)(2)(A).

Lastly, in addition to the foregoing provisions applicable to public companies, BST will remain subject to the Commission's Part 32 chart of accounts, which enables the Commission to monitor BST's financial information for regulatory purposes. Thus, BST will continue to record and report information pursuant to these rules, including ARMIS reporting.[120] However, the elimination of the cost assignment rules will affect the makeup of some of the ARMIS reports because certain data would no longer be available through ARMIS. This would include ARMIS Report 495A (Forecast of Investment Usage), Report 495B (Actual Usage of Investment), and Report 43-04 (Access), which would no longer be produced.[121] Other reports that would be affected but would continue to be produced include ARMIS Report 43-01 (Annual Summary), Report 43-02 (USOA Report), and Report 43-03 (Joint Cost Report). These ARMIS Reports involve data that are no longer necessary, and would not be provided after the granting of this Petition. A summary of the impact of this Petition on ARMIS reporting is attached as Appendix 9.

In summary, it is in the public interest for BellSouth to be treated as much as possible like all other public companies for accounting purposes. There is ample federal regulatory governance over BellSouth's financial reporting and use of accounting in those reports. Further, because the Commission's role in monitoring BellSouth's financial data for regulatory purposes will be preserved *via* Part 32 and ARMIS, there remains an element of enhanced public oversight specific to the Commission. The limited forbearance requested in this Petition is clearly in the public interest.

[120] There are two rules from which BST is seeking forbearance that are codified in Part 32. However, these rules are not part of the USOA, but relate specifically to rules that are further codified in Part 64, subpart I.

[121] In 2004, only the RBOCs provided data for these three reports. *See* http://www.fcc.gov/wcb/armis.

3. **<u>As the market becomes more competitive, the public interest is served by jettisoning outdated accounting rules.</u>**

The Commission previously observed that "changes in the competitive conditions of local telecommunications markets in the future may cause us to re-examine the continued need for our Part 64 cost allocation rules." [122] Similarly, in its *2000 Biennial Regulatory Review*, the Commission recognized *"that the national marketplace in which the regulated LECs operate continues to move toward a competitive model,"* and acknowledged the need to "strike an appropriate balance between the operations of the free market and a continuing need for some regulation."[123] With the current level of competition in the communications market, BST submits that the only way for the Commission to strike the "appropriate balance" about which it was rightfully concerned is by granting this Petition.

Almost a decade after the passage of the 1996 Act, communications competition is flourishing. According to the Commission's most recent report on local telephone competition, CLECs maintained 18.5% of the total end-user switched access lines nationally.[124] This translates into 32.9 million lines, which is up over 3 million lines since December 2003. CLECs achieved this increase while ILECs lost 8 million lines.

However, these statistics are misleading because the line between the local and long distance market has been nearly erased, particularly with the proliferation of wireless service. The number of wireless subscribers has grown from approximately 55 million in 1997 to more than 182 million by year end 2004, with more than 23 million new wireless subscribers being

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[122] *Accounting Safeguards Order*, 11 FCC Rcd at 17,661, ¶ 271.

[123] *2000 Biennial Regulatory Review, supra,* 16 FCC Rcd at 19,913, ¶ 2 (emphasis added)

[124] Ind. Anal. & Tech. Div., Wireline Competition Bureau, FCC, *Local Telephone Competition: Status as of December 31, 2004*, at Table 1 (July 2005). This was representative of the lines within BST's region with a range of 10% in Mississippi to 20% in Georgia.