

47 C.F.R. PART 69 SUBPART D	Action Requested	
	For-bear	No Action
Subpart D--Apportionment of Net Investment Sec. 69.306 Central office equipment (COE).		
(a) The Separations Manual categories shall be used for purposes of apportioning investment in such equipment except that any Central office equipment attributable to local transport shall be assigned to the Transport elements.	X	
(b) COE Category 1 (Operator Systems Equipment) shall be apportioned among the interexchange category and the access elements as follows: Category 1 that is used for intercept services shall be assigned to the Local Switching element. Category 1 that is used for directory assistance shall be assigned to the Information element. Category 1 other than service observation boards that is not assigned to the Information element and is not used for intercept services shall be assigned to the interexchange category. Service observation boards shall be apportioned among the interexchange category, and the Information and Transport access elements based on the remaining combined investment in COE Category 1, Category 2 and Category 3.	X	
(c) COE Category 2 (Tandem Switching Equipment) that is deemed to be exchange equipment for purposes of the Modification of Final Judgment in United States v. Western Electric Co. shall be assigned to the tandem switching charge subelement and the interconnection charge element. COE Category 2 which is associated with the signal transfer point function shall be assigned to the local switching category. COE Category 2 which is used to provide transmission facilities between the local exchange carrier's signalling transfer point and the database shall be assigned to the Line Information Database subelement at Sec. 69.120(a). All other COE Category 2 shall be assigned to the interexchange category.	X	
(d) COE Category 3 (Local Switching Equipment) shall be assigned to the Local Switching element except as provided in paragraph (a) of this section; and that, (1) For telephone companies subject to price cap regulation set forth in part 61 of this chapter, line-side port costs shall be assigned to the Common Line rate element; and (2) Beginning January 1, 2002, for non-price cap local exchange carriers, line-side port costs shall be assigned to the Common Line rate element. Such amount shall be determined after any local switching support has been removed from the interstate Local Switching revenue requirement. Non-price cap local exchange carriers may use thirty percent of the interstate Local Switching revenue requirement, minus any local switching support, as a proxy for allocating line port costs to the Common Line category.	X	
(e) COE Category 4 (Circuit Equipment) shall be apportioned among the interexchange category and the Common Line, Transport, and Special Access elements. COE Category 4 shall be apportioned in the same proportions as the associated Cable and Wireless Facilities; except that any DS1/voice-grade multiplexer investment associated with analog local switches and assigned to the local transport category by this section shall be reallocated to the local switching category.	X	
[52 FR 37312, Oct. 6, 1987, as amended at 57 FR 54722, Nov. 20, 1992; 58 FR 30995, May 28, 1993; 62 FR 31938, June 11, 1997; 66 FR 59732, Nov. 30, 2001]		

47 C.F.R. PART 69 SUBPART D	Action Requested	
	For-bear	No Action
<p>Subpart --Apportionment of Net Investment Sec. 69.307 General support facilities.</p> <p>(a) General purpose computer investment used in the provision of the Line Information Database sub-element at Sec. 69.120(b) shall be assigned to that sub-element.</p> <p>(b) General purpose computer investment used in the provision of the billing name and address element at Sec. 69.128 shall be assigned to that element.</p> <p>(c)(1) Until June 30, 2002, for all local exchange carriers not subject to price cap regulation and for other carriers that acquire all of the billing and collection services that they provide to interexchange carriers from unregulated affiliates through affiliate transactions, from unaffiliated third parties, or from both of these sources, all other General Support Facilities investments shall be apportioned among the interexchange category, the billing and collection category, and Common Line, Local Switching, Information, Transport, and Special Access elements on the basis of Central Office Equipment, Information Origination/Termination Equipment, and Cable and Wire Facilities, combined.</p> <p>(2) Beginning July 1, 2002, for all local exchange carriers that acquire all of the billing and collection services that they provide to interexchange carriers from unregulated affiliates through affiliate transactions, from unaffiliated third parties, or from both of these sources, all other General Support Facilities investments shall be apportioned among the interexchange category, the billing and collection category, and Common Line, Local Switching, Information, Transport, and Special Access elements on the basis of Central Office Equipment, Information Origination/Termination Equipment, and Cable and Wire Facilities, combined.</p> <p>(d) For local exchange carriers subject to price cap regulation and not covered by Section 69.307(c), a portion of General purpose computer investment (Account 2124), investment in Land (Account 2111), Buildings (Account 2121), and Office equipment (Account 2123) shall be apportioned to the billing and collection category on the basis of the Big Three Expense Factors allocator, defined in Section 69.2 of this Part, modified to exclude expenses that are apportioned on the basis of allocators that include General Support Facilities investment. The remaining portion of investment in these four accounts together with all other General Support Facilities investments shall be apportioned among the interexchange category, the billing and collection category, and Common Line, Local Switching, Information, Transport, and Special Access Elements on the basis of Central Office Equipment, Information Origination/Termination Equipment, and Cable and Wire Facilities, combined.</p> <p>(e) Beginning July 1, 2002, for non-price cap local exchange carriers not covered by Sec. 69.307(c)(2), a portion of General purpose computer investment shall be apportioned to the billing and collection category on the basis of the Big Three Expense Factors allocator, defined in Sec. 69.2, modified to exclude expenses that are apportioned on the basis of allocators that include General Support Facilities investment. The remaining General Support Facilities investments shall be apportioned among the interexchange category, the billing and collection category, and Common Line, Local Switching, Information, Transport, and Special Access Elements on the basis of Central Office Equipment, Information Origination/Termination Equipment, and Cable and Wire Facilities, combined.</p> <p>[58 FR 30995, May 28, 1993, as amended at 58 FR 36145, July 6, 1993; 62 FR 31939, June 11, 1997; 62 FR 40464, July 29, 1997; 62 FR 65622, Dec. 15, 1997; 66 FR 59732, Nov. 30, 2001]</p>	X	
	X	
		X
	X	
		X
Subpart D--Apportionment of Net Investment Sec. 69.308 [Reserved]		X

47 C.F.R. PART 69 SUBPART D	Action Requested	
	For- bear	No Action
<p>Subpart D--Apportionment of Net Investment Sec. 69.309 Other investment.</p> <p>Investment that is not apportioned pursuant to Sec. Sec. 69.302 through 69.307 shall be apportioned among the interexchange category, the billing and collection category and access elements in the same proportions as the combined investment that is apportioned pursuant to Sec. Sec. 69.303 through 69.307.</p>	X	
<p>Subpart D--Apportionment of Net Investment Sec. 69.310 Capital leases.</p> <p>Capital Leases in Account 2680 shall be directly assigned to the appropriate interexchange category or access elements consistent with the treatment prescribed for similar plant costs or shall be apportioned in the same manner as Account 2001.</p>	X	

PART 69-- Access Charges
Subpart E-- Apportionment of Expenses

47 C.F.R. PART 69 SUBPART E	Action Requested	
	For-bear	No Action
Subpart E--Apportionment of Expenses Sec. 69.401 Direct expenses.		
(a) Plant Specific Operations Expenses in Accounts 6110 and 6120 shall be apportioned among the interexchange category, the billing and collection category and appropriate access elements on the following basis: (1) Account 6110--Apportion on the basis of other investment apportioned pursuant to Sec. 69.309. (2) Account 6120--Apportion on the basis of General and Support Facilities investment pursuant to Sec. 69.307.	X	
(b) Plant Specific Operations Expenses in Accounts 6210, 6220, and 6230, shall be apportioned among the interexchange category and access elements on the basis of the apportionment of the investment in Accounts 2210, 2220, and 2230, respectively; provided that any expenses associated with DSI/voice-grade multiplexers, to the extent that they are not associated with an analog tandem switch, assigned to the local transport category by this paragraph shall be reallocated to the local switching category; provided further that any expenses associated with common channel signalling included in Account 6210 shall be assigned to the local transport category.	X	
(c) Plant Specific Operations Expenses in Accounts 6310 and 6410 shall be assigned to the appropriate investment category and shall be apportioned among the interexchange category and access elements in the same proportions as the total associated investment.	X	
(d) Plant Non Specific Operations Expenses in Accounts 6510 and 6530 shall be apportioned among the interchange category, the billing and collection category, and access elements in the same proportions as the combined investment in COE, IOT, and C&WF apportioned to each element and category.	X	
(e) Plant Non Specific Operations Expenses in Account 6540 shall be assigned to the interexchange category.	X	
(f) Plant Non Specific Operations Expenses in Account 6560 shall be apportioned among the interexchange category, the billing and collection category, and access elements in the same proportion as the associated investment.	X	
(g) Amortization of embedded customer premises wiring investment shall be deemed to be associated with Sec. 69.303(b) IOT investment for purposes of the apportionment described in paragraph (c) of this section.	X	
[52 FR 37313, Oct. 6, 1987, as amended at 62 FR 31939, June 11, 1997]		

47 C.F.R. PART 69 SUBPART E	Action Requested	
	For- bear	No Action
<p>Subpart E--Apportionment of Expenses Sec. 69.402 Operating taxes (Account 7200).</p> <p>(a) Federal income taxes, state and local income taxes, and state and local gross receipts or gross earnings taxes that are collected in lieu of a corporate income tax shall be apportioned among the interexchange category, the billing and collection category and all access elements based on the approximate net taxable income on which the tax is levied (positive or negative) applicable to each element and category.</p> <p>(b) All other operating taxes shall be apportioned among the interexchange category, the billing and collection category and all access elements in the same manner as the investment apportioned to each element and category pursuant to Sec. 69.309 Other Investment.</p>	X	
<p>Subpart E--Apportionment of Expenses Sec. 69.403 Marketing expense (Account 6610).</p> <p>Marketing expense shall be apportioned among the interexchange category and all access elements in the same proportions as the combined investment that is apportioned pursuant to Sec. 69.309.</p>	X	
<p>Subpart E—Apportionment of Expenses Sec. 69.404 Telephone operator services expenses in Account 6620.</p> <p>Telephone Operator Services expenses shall be apportioned among the interexchange category, and the Local Switching and Information elements based on the relative number of weighted standard work seconds. For those companies who contract with another company for the provision of these services, the expenses incurred shall be directly assigned among the interexchange category and the Local Switching and Information elements on the basis of the bill rendered for the services provided.</p>	X	
<p>Subpart E--Apportionment of Expenses Sec. 69.405 Published directory expenses in Account 6620.</p> <p>Published Directory expenses shall be assigned to the Information element.</p>	X	

47 C.F.R. PART 69 SUBPART E	Action Requested	
	For- bear	No Action
<p>Subpart E--Apportionment of Expenses Sec. 69.406 Local business office expenses in Account 6620.</p> <p>(a) Local business office expenses shall be assigned as follows:</p> <p>(1) End user service order processing expenses attributable to presubscription shall be apportioned among the Common Line, Switching, and Transport elements in the same proportion as the investment apportioned to those elements pursuant to Sec. 69.309.</p> <p>(2) End user service order processing, payment and collection, and billing inquiry expenses attributable to the company's own interstate private line and special access service shall be assigned to the Special Access element.</p> <p>(3) End user service order processing, payment and collection, and billing inquiry expenses attributable to interstate private line service offered by an interexchange carrier shall be assigned to the billing and collection category.</p> <p>(4) End user service order processing, payment and collection, and billing inquiry expenses attributable to the company's own interstate message toll service shall be assigned to the interexchange category. End user service order processing, payment and collection, and billing inquiry expenses attributable to interstate message toll service offered by an interexchange carrier shall be assigned to the billing and collection category. End user payment and collection and billing inquiry expenses attributable to End User Common Line access billing shall be assigned to the Common Line element.</p> <p>(5) End user service order processing, payment and collection, and billing inquiry expenses attributable to TWX service shall be assigned to the Special Access element.</p> <p>(6) Interexchange carrier service order processing, payment and collection, and billing inquiry expenses attributable to private lines and special access shall be assigned to the Special Access element.</p> <p>(7) Interexchange carrier service order processing, payment and collection, and billing inquiry expenses attributable to interstate switched access and message toll, shall be apportioned among the Common Line, Local Switching and Transport elements in the same proportion as the investment apportioned to those elements pursuant to Sec. 69.309.</p> <p>(8) Interexchange carrier service order processing, payment and collection, and billing inquiry expenses attributable to billing and collection service shall be assigned to the billing and collection category.</p> <p>[52 FR 37313, Oct. 6, 1987, as amended at 62 FR 31939, June 11, 1997]</p>	X	

47 C.F.R. PART 69 SUBPART E	Action Requested	
	For-bear	No Action
<p>Subpart E--Apportionment of Expenses Sec. 69.407 Revenue accounting expenses in Account 6620.</p> <p>(a) Revenue accounting expenses that are attributable to End User Common Line access billings shall be assigned to the Common Line element.</p> <p>(b) Revenue Accounting Expenses that are attributable to carrier's carrier access billing and collecting expense shall be apportioned among all carrier's carrier access elements except the Common Line element. Such expenses shall be apportioned in the same proportion as the combined investment in COE, C&WF and IOT apportioned to those elements.</p> <p>(c) Revenue Accounting Expenses allocated to the interstate jurisdiction that are attributable to the provision of billing name and address information shall be assigned to the Billing Name and Address element.</p> <p>(d) All other Revenue Accounting Expenses shall be assigned to the billing and collection category.</p> <p>[52 FR 37313, Oct. 6, 1987, as amended at 58 FR 65671, Dec. 16, 1993]</p>	X	
<p>Subpart E--Apportionment of Expenses Sec. 69.408 All other customer services expenses in Account 6620.</p> <p>All other customer services expenses shall be apportioned among the Interexchange category, the billing and collection category and all access elements based on the combined expenses in Sec. Sec. 69.404 through 69.407.</p> <p>[52 FR 37313, Oct. 6, 1987, as amended at 54 FR 3456, Jan. 24, 1989]</p>	X	
<p>Subpart E--Apportionment of Expenses Sec. 69.409 Corporate operations expenses (included in Account 6720).</p> <p>All corporate operations expenses shall be apportioned among the interexchange category, the billing and collection category and all access elements in accordance with the Big 3 Expense Factor as defined in Sec. 69.2(f).</p>	X	
<p>Subpart E--Apportionment of Expenses Sec. 69.411 Other expenses.</p> <p>Except as provided in Sec. Sec. 69.412, 69.413, and 69.414, expenses that are not apportioned pursuant to Sec. Sec. 69.401 through 69.409 shall be apportioned among the interexchange category and all access elements in the same manner as Sec. 69.309 Other investment.</p> <p>[62 FR 31639, June 11, 1997]</p>	X	
<p>Subpart E--Apportionment of Expenses Sec. 69.412 Non participating company payments/receipts.</p> <p>For telephone companies that are not association Common Line tariff participants, the payment or receipt of funds described in Sec. 69.612(a) and (b) shall be apportioned, respectively, as an addition to or a deduction from their common line revenue requirement.</p>	X	

SECTION 220 – Accounts, Records and Memoranda

47 U.S.C. § 220(a)(2)	Action Requested	
	For- bear	No Action
<p>Sec. 220. Accounts, records, and memoranda</p> <p>(a) Forms</p> <p>.....</p> <p>(2) The Commission shall, by rule, prescribe a uniform system of accounts for use by telephone companies. Such uniform system shall require that each common carrier shall maintain a system of accounting methods, procedures, and techniques (including accounts and supporting records and memoranda) which shall ensure a proper allocation of all costs to and among telecommunications services, facilities, and products (and to and among classes of such services, facilities, and products) which are developed, manufactured, or offered by such common carrier.</p> <p>.....</p>	<p>X¹⁵</p>	

¹⁵ The Petition seeks limited forbearance of 47 U.S.C. § 220(a)(2) to the extent that provision contemplates separate accounting for non-regulated costs.

ATTACHMENT 2

Service Representative Study Results - Official Results 02
Profiles by Market Segment - (Excludes NCPT, Includes Billing) (Weighted Ratios)

Page 1 of 2

16-Oct-06

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Data from: 10/05 thru: 09/06

Market Business**Company: SBC- Midwest**

<u>Product Name</u>	<u>Product</u>	<u>Allocated Occ</u>	<u>Allocated Sample Common</u>	<u>Allocated JWTs</u>	<u>Allocated Order</u>	<u>Total Secs</u>	<u>Weighte Product</u>
<u>Affiliate</u>							
AT & T Customer Care	1217	201	20	0	0		
AT & T Joint Marketing	2313	425	69	0	0		
Cingular Wireless	2559	553	49	0	0		
DSL with Yahoo	82018	21499	2613	0	1251	107380	0.1534
FreedomLink for DSL	121	19	2	0	0		
SBC DISH Network	146	50	2	0	0		
SBC LD Account Codes	313	25	13	0	0		
SBC LD Carrier Discussion	23194	13990	1548	0	2229		
SBC LD Intl Calling Plans	7698	2608	274	0	138		
SBC LD post sale care	202	47	4	0	0		
SBC LD Toll Free Svc	8410	2754	332	0	1649		
SBC Paging	724	230	22	0	0		
Unified Comm/SBC Messaging	2274	487	99	0	534		
Yahoo Dialup	3333	1053	109	0	0		
Yellow Page Directory	5194	2467	282	0	386		
						Affiliate Total=	
<u>Non-Regulated</u>							
Business CPE	8402	1919	256	0	0		
Consumer CPE	24	12	0	0	0		

This report has been altered to remove competitively sensitive data.

Service Representative Study Results - Official Results 02
Profiles by Market Segment - (Excludes NCPT, Includes Billing) (Weighted Ratios)

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Data from: 10/05 thru: 09/06

Market Business**Company: SBC- Midwest**

<u>Product Name</u>	<u>Product</u>	<u>Allocated Occ</u>	<u>Allocated Sample Common</u>	<u>Allocated JWTS</u>	<u>Allocated Order</u>	<u>Total Secs</u>	<u>Weighte Product</u>
<u>Non-Regulated</u>							
Inline & Inline+/Linebacker	2005	938	98	0	61		
IW and Jacks Installation	10064	5238	524	0	789	16615	0.0237
Sig/Enhanced Listing	334	220	26	0	0		
Voice Mail - Midwest	18673	4433	637	0	574	24317	0.0347
						Non-Regulated Total=	
<u>Regulated</u>							
3rd Party Block	846	166	46	0	2		
800 Service	3350	1089	98	0	592		
976/900 Blocking	224	139	31	0	39		
Access (Res)	841	240	15	0	0		
Access Trunks - PBX	135	16	4	0	0		
Assigning Number	8474	3795	1046	0	349		
AT & T Billing & Collections	1137	407	31	0	0		
Billing Related Other	69779	18522	2390	0	0		
Billing Related Svc Order	1588	1428	124	0	239		
Business Access Lines	104565	50211	5355	0	3459		
Business Plan	55	20	7	0	0		
Caller ID Blocking	12	3	0	0	0		
Centrex	2327	1357	79	0	33		
Cingular Billing	471	54	7	0	0		

This report has been altered to remove competitively sensitive data.

ATTACHMENT 3

REGULATORY BACKGROUND

As demonstrated in greater detail below, the cost assignment rules at issue in this Petition are no longer connected (and certainly not “strongly connected”) to the legitimate statutory purposes of ensuring that AT&T provides service at just and reasonable, nondiscriminatory rates. To appreciate this position fully, it is important to understand: (1) rate-of-return regulation and the role of cost assignment rules in establishing rates under this regulatory scheme; (2) price cap regulation, under which rates are regulated without regard to costs; and (3) that AT&T is no longer subject to rate-of-return in any jurisdiction. Against this regulatory backdrop, the merits of AT&T’s Petition become self-evident.

A. Ratemaking Under Rate-Of-Return Regulation

1. How rate-of-return regulation worked

For decades, federal and state commissions regulated the local and long distance rates charged by AT&T and the RBOCs pursuant to rate-of-return regulation. Rate-of-return regulation emanated from the legal principle, established nearly 80 years ago, that regulators were required to allow carriers to charge rates, which, on a prospective basis, would provide an opportunity for carriers to earn a fair return on their property dedicated to public use.¹ The legal principle developed in an era when communications “property dedicated to public use” meant use for only “plain old [regulated] telephone service” provided over analog networks by monopoly providers.

Rate-of-return regulation was a “cost plus” system which required a carrier to determine the amount of investment in its regulated rate base as well as the expenses the carrier incurred to

¹ See *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Hope Natural Gas v. West Virginia*, 274 U.S. 284 (1927).

provide services during the year.² Detailed tracking of investment and expense was assumed to be, and was, readily accomplished as long as the networks remained single purpose and analog.³

The rate-of-return ratemaking process began with the regulatory agency's establishment of a test period. The test period concept was devised to determine the revenue and expenses that would be *representative* of the rate-effective period. For interstate ratemaking purposes, the Commission's test period was usually a prospective 12-month period, that is, the test period projected revenue and expenses for the immediate 12-month future.⁴

Once the test period was determined, the revenues and expenses for that period were forecasted. This was a two-step process. The first step was to determine the projected regulated rate base. The rate base was the carrier's assets that were "used and useful" for providing services and typically included, but was not limited to, the telephone plant held in service, plant in construction, and material and supplies. These amounts would be reduced by accumulated depreciation on the plant and various other adjustments that the regulatory agency required to be backed out of the rate base.⁵ Once determined, the rate base was multiplied by the authorized

² *Second Report and Order*, 5 FCC Rcd at 6787 ¶ 1 ("[LECs], in providing the critical telecommunications link between a customer's premises and the interexchange networks, have until now been regulated under a "cost-plus" system . . . in which rates . . . are based on costs plus a return on invested capital.")

³ The task became more arduous as new technology and deregulatory policies introduced multi-use facilities, a development that has reached a crescendo in today's environment of broadband and IP networks.

⁴ *See e.g.*, 47 C.F.R. 61.38(b)(1)(ii).

⁵ *See* 47 C.F.R. 65, subpart G, for a description of allowable and disallowable assets a rate of return carrier uses to establish its federal rate base.

rate of return⁶ to calculate the return on investment that the carrier would be allowed to achieve for the period.

The next step was to project the operating expenses for the test period. Examples of projected expenses included, but were not limited to, plant specific, plant non-specific, customer operations, corporate expenses, operating taxes, and depreciation. The total operating expenses were then added to the return on investment calculated above to determine the “revenue requirement” for the test period. The revenue requirement was allocated over the types of services in order to establish rates for those services for the upcoming year.

The following example helps illustrate the concept of interstate rate-of-return ratemaking:

Revenue Requirement Calculation

Additions:

Telephone plant in Service	11,000
Plant under Construction	1,000
Materials and Supplies	<u>1,000</u>
<i>Total Additions</i>	13,000

Deductions:

Accumulated depreciation	2,000
Accumulated Deferred Fed. Income Tax	500
Customer Deposit	<u>500</u>
Total Deductions	(3,000)

Regulated Rate Base	<u>10,000</u>
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Regulated Rate Base	10,000
Authorized Rate of Return	<u>11%</u>

ROI Component of Revenue Requirement	<u>1,100</u>
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Operating Expenses:

Plant Specific	2,000
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⁶ The authorized rate of return is established by various methods sanctioned by the regulatory agency.

Plant Non-Specific	500
Customer Operations	1,500
Corporate Operations	<u>100</u>
<i>Sub Total</i>	4,100
Depreciation	<u>1,900</u>
	6,000
Income Tax	<u>400</u>
Total Regulated Expenses	<u>6,400</u>
Total Projected Revenue Requirement For Period (Regulated Expenses + ROI Component)	<u>7,500</u>

Thus, pursuant to these calculations, the carrier would price its service(s) in order to achieve revenue of \$7,500 for the upcoming year.

Under rate-of-return ratemaking, regulators used actual regulated costs to monitor a carrier's performance. That is, at the end of the year, a carrier's realized rate-of-return was computed from the actual regulated revenue, investment, and expense amounts for that year. To the extent a carrier realized a rate-of-return in excess of approved levels, the carrier might be required to reduce its rates for the next year by the amount of the over-earning.⁷

Continuing the above example, at the end of the year, if the carrier's actual financial results showed that the carrier had earned a net operating income of \$1,400 with an actual regulated rate base of \$10,000, the actual rate-of-return would be 14% (1,400/10,000), 3% above the authorized rate. If the regulatory agency required excess earnings to be returned to customers, the carrier would have to adjust its revenue requirement, and its rates, downward the next year to reflect the over-earning in the current year. Conversely, if actual financial results

⁷ Under the Commission's rules, a carrier's realized rate-of-return was measured over a two-year period. At the conclusion of the two-year period, if a carrier exceeded the maximum allowable rate-of-return, the carrier had to refund the excess return by lowering rates. See 47 C.F.R. § 65.701.

showed a net operating income of \$1,100 with a rate base of \$10,000, the carrier would have achieved the hypothetically authorized rate of 11% and no adjustment would be necessary.

2. Cost data is necessary under rate-of-return regulation

The explanation of rate-of-return regulation, above, underscores the need for access to accurate historical cost data under this traditional form of regulation. Actual financial results reflecting increases or decreases in historical costs factored directly into the determination of whether rates would be adjusted upward or downward in any given rate cycle. Thus, the Commission – through a gradually evolving regulatory process – wanted to ensure that costs were meticulously monitored and assigned. The cost assignment rules (for which AT&T now seeks forbearance) served that purpose.

In order for this traditional ratemaking process to be properly monitored at the federal level, the Commission established the USOA. The USOA, first codified in Part 31 but now found in Part 32, established the Chart of Accounts that each company subject to the rules must follow and defined the types of revenue, investment, and expenses that could be recorded in each Commission-prescribed account. Under rate-of-return regulation, these accounts are the starting point for all FCC accounting rules and formed the basis for determining the actual regulated rate base and operating expenses for the year.

Additionally, because the telephone company networks and resources were used to provide both interstate and intrastate services, the Commission developed rules (Part 36 – Separations, formerly Part 67) to separate investment and expenses into the federal and state jurisdictions. The separations process ensured that the costs flowing into the interstate rate-of-return process were “used and useful” for providing interstate services. The separations process

also was important for state ratemaking purposes, which was uniformly operating under rate-of-return regulation at the time.

Through the *Computer Inquiry* line of cases,⁸ the Commission eventually permitted AT&T and the RBOCs to provide “enhanced” or “information” services and determined that, since such services were competitive, they should be treated as “non-regulated.” While initially offered only through structurally separate affiliates, these services were subsequently allowed by the Commission to be provided on an integrated basis.⁹

⁸ *Regulatory & Policy Problems Presented by the Interdependence of Computer & Communications Services & Facilities*, 28 FCC2d 291 (1970); 28 FCC2d 267 (1971), *aff'd in part sub nom. GTE Service Corp. v. FCC*, 474 F.2d 724 (2d Cir. 1973), *decision on remand*, 40 FCC2d 293 (1973). *Amendment of Section 64.702 of the Commission's Rules and Regulations*, 77 FCC2d 384 (1980), *recon.*, 84 FCC2d 50 (1980), *further recon.*, 88 FCC2d 512 (1981), *affirmed sub nom., Computer and Communications Industry Ass'n v. FCC*, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983); *Amendment of Section 64.702 of the Commission's Rules and Regulations*, CC Docket No. 85-229, Phase I, 104 FCC2d 958 (1986), *recon.*, 2 FCC Rcd 3035 (1987), *further recon.*, 3 FCC Rcd 1135 (1988), *second further recon.*, 4 FCC Rcd 5927 (1989), (*Computer III Phase I Order and Computer III Phase I Reconsideration Order vacated California v. FCC*, 905 F.2d 1217 (9th Cir. 1990)); Phase II, 2 FCC Rcd 3072 (1987), *recon.*, 3 FCC Rcd 1150 (1988), *further recon.*, 4 FCC Rcd 5927 (1989) (*Computer III Phase II Order vacated California I*, 905 F.2d 1217 (9th Cir. 1990)); *Computer III Remand Proceeding*, 5 FCC Rcd 7719 (1990), *recon.*, 7 FCC Rcd 909 (1992), *pets. for review denied, California v. FCC*, 4 F.3d 1505 (9th Cir. 1993); *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards*, 6 FCC Rcd 7571 (1991), *BOC Safeguards Order vacated in part and remanded, California v. FCC*, 39 F.3d 919 (9th Cir. 1994), *cert. denied*, 514 U.S. 1050 (1995). *See also Bell Operating Companies' Joint Petition for Waiver of Computer II Rules*, 10 FCC Rcd 1724 (1995); *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services*, 10 FCC Rcd 8360 (1995); *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Review – Review of Computer III and ONA Safeguards and Requirements*, CC Docket Nos. 95-20, 98-10; *Further Notice of Proposed Rulemaking, Report and Order*, 13 FCC Rcd 6040 (1998), *Report and Order*, 14 FCC Rcd 4289 (1999), *on reconsideration, Order*, 14 FCC Rcd 21628 (1999).

⁹ *See generally In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, 11 FCC Rcd 17539 at 17542-43 (1996) (“*Accounting Safeguards Order*”).

The Commission determined, however, that under rate-of-return regulation, costs associated with these integrated non-regulated services should not be borne by regulated ratepayers. Accordingly, the Commission developed a means for companies to allocate costs between regulated and non-regulated operations in the *Joint Cost Order*.¹⁰

The *Joint Cost Order* established the Part 64 cost allocation rules as an overlay on the Part 32 USOA. All costs were still recorded in the prescribed USOA accounts. But, because carriers were only allowed to use regulated costs for ratemaking purposes, costs had to be allocated between regulated and non-regulated activities before flowing into the separations process and onto the rate-of-return process (either federal or state).

These cost assignment rules, now codified in Parts 32, 64, 36 and 69, established a “four-step regulatory process that began with an ILEC’s accounting system and ended with the establishment of rates for the ILEC’s interstate and intrastate regulated services” as follows:

First, carriers record their costs, including investments and expenses, into various accounts in accordance with the . . . USOA Second, carriers assign the costs in these accounts to regulated and nonregulated activities in accordance with Part 64 of the Commission’s rules to ensure that the costs of non-regulated activities will not be recovered in regulated interstate service rates. Third, carriers separate the regulated costs between the intrastate and interstate jurisdictions in accordance with the Commission’s Part 36 separations rules. Finally, carriers apportion the interstate regulated costs among the interexchange services and rate elements that form the cost basis for their interstate access tariffs. Carriers perform this apportionment in accordance with Part 69 of the Commission’s rules. The intrastate costs that result from application of the Part 36 rules form the foundation for determining carriers’ intrastate rate base, expenses, and taxes.¹¹

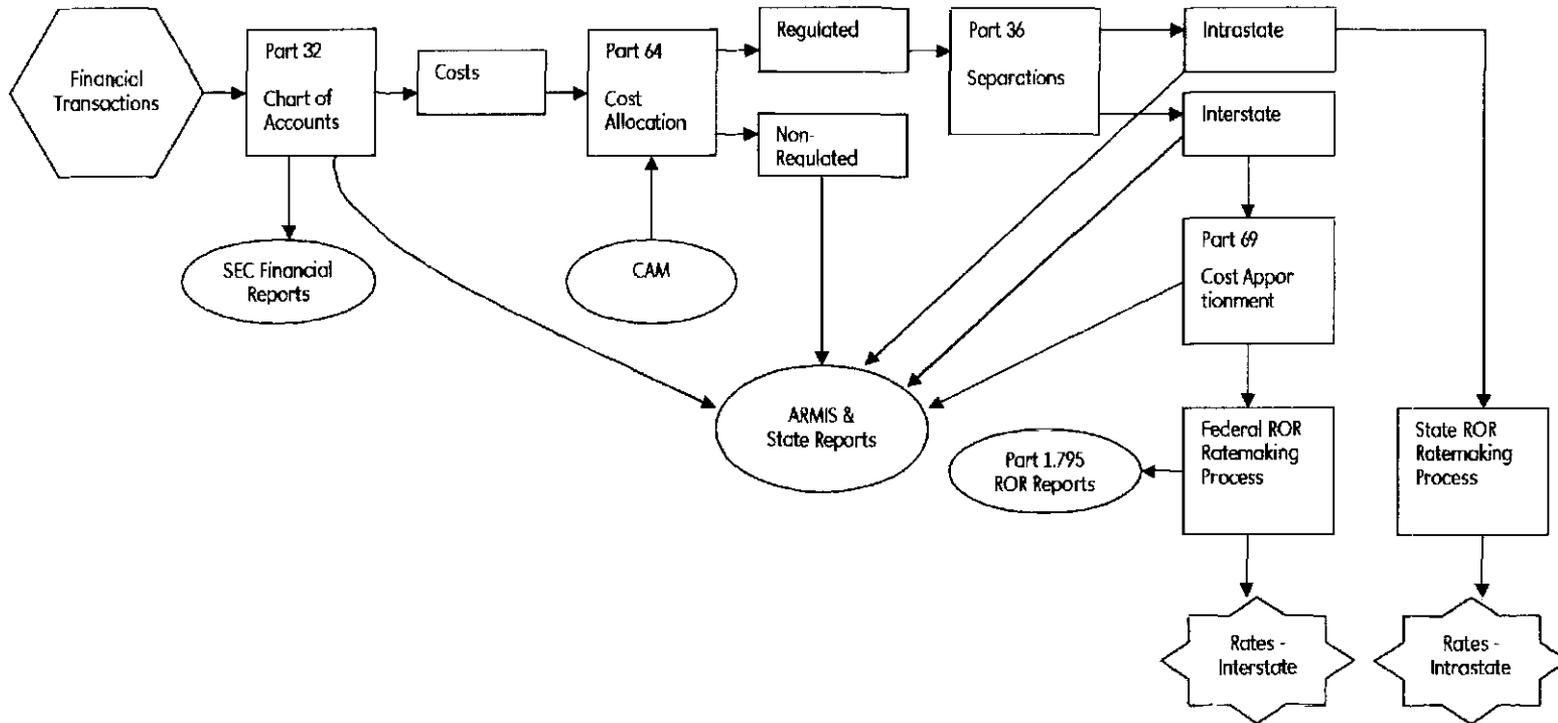
¹⁰ See *Separation of Costs of Regulated Telephone Service from Costs of Non-regulated Activities, Report and Order*, CC Docket No. 86-111, 2 FCC Rcd 1298, 1330-31 (“*Joint Cost Order*”) (1987).

¹¹ See *Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Report and Order*, 16 FCC Rcd 11382, 11384-85, ¶ 3 (2001), adopting *Recommended Decision*, 15 FCC Rcd 13,160 (2000).

As the Commission states, and as Chart 1 clearly illustrates, the culmination of the cost allocation process under rate-of-return regulation was “the establishment of rates.”

1. Cost and Ratemaking Under Rate-of-Return

Under Rate-of-Return, results of cost assignment rules flowed directly into rates.



6

B. Establishing Prices under Price Cap Regulation.

1. How price cap regulation works

AT&T has been under totally “pure” price cap regulation at the federal level since 2000.¹² AT&T’s federally regulated access prices are governed by the Commission’s price cap rules contained in Part 61. Under price cap regulation, an ILEC’s prices cannot exceed certain prescribed limits; its costs are irrelevant. For price cap ILECs, price changes are limited by the price cap formula, which incorporates changes in inflation and other non-accounting factors, such as demand changes. These relationships are depicted in the federal price cap formula:

$$\text{New year Price Cap Index (“PCI”) = Last year’s Price Cap [(Inflation - Productivity Adjustment) +/- Exogenous Cost Factor].}^{13}$$

Under the FCC’s rules, the PCI is currently calculated each year using the Gross Domestic Product Price Index (“GDP-PI”) for inflation and a pre-established productivity factor (“X Factor”).¹⁴ The PCI also is affected by exogenous changes (costs outside the carrier’s control such as new legislation or regulation), which are discussed in more detail below.

The Commission has established a set of baskets for grouping various types of services. These baskets are “broad groupings of LEC services, each of which is subject to its own cap.”¹⁵ Multiple service offerings can reside in a given basket. Carriers compare the historic demand multiplied by prospective rates to the revenue cap. Companies can change their tariff rates as market conditions warrant (raise the price of some services, lower the price of others) so long as

¹² “Pure” price cap regulation means that the carrier is not subject to a “sharing” component to manage over-earnings or allowed to file a lower formula adjustment for under-earnings. See *Access Charge Reform*, CC Docket No. 96-262, *Sixth Report and Order*, 15 FCC Rcd 12962 (2000).

¹³ See *Second Report and Order*, 5 FCC Rcd at 6786.

¹⁴ See 47 C.F.R. § 61.45 (a) and (b).

¹⁵ *Second Report and Order*, 5 FCC Rcd at ¶ 11.

the total of all services within a given basket are within an acceptable price cap range as defined by Commission rules.¹⁶ Lowering of tariff rates only becomes mandatory when the total of all services in that basket exceeds the price cap.

Finally, ILECs also must calculate Service Band Indices (“SBI”) for each category of service within a basket. These pricing bands “permit prices for service categories to increase on a streamlined basis no more than plus or minus 5 percent per year, adjusted for the change in the price cap.”¹⁷ Thus, in order for any tariff filing to be deemed “reasonable,” the SBI for any service cannot exceed five percent above or below the previous SBI for that service. The API and the SBI were implemented to protect against cross-subsidization between the various baskets of price cap services as well as those services not in price caps.¹⁸ Neither SBI nor API contains any carrier cost element.

Below is an example of how the price cap process works for AT&T today for a representative price cap basket (*e.g.*, common-line, traffic-sensitive, special access, *etc.*):¹⁹

Price Cap Calculations:

Adjustment to Price Cap Index (PCI)

¹⁶ AT&T must calculate an Actual Price Index (“API”) for each basket, which is an index of the level of aggregate rate element rates within the basket. The API cannot exceed the PCI for any basket. There is no carrier cost element in the API determination.

¹⁷ *Second Report and Order*, 5 FCC Rcd at ¶ 11.

¹⁸ *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*”) (“[T]he service band indices (SBIs) were designed to limit cross-subsidization between different types of services within a basket ...”).

¹⁹ This example assumes pure price cap regulation under which the carrier is not subject to a “sharing” component or allowed to file a lower formula adjustment for below cap earnings.