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Controlling Cross-Subsidy Between Regulated and Competitive Services

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The Honorable Edward J. Markey
Chairman, Subcommittee on
Telecommunications and Finance
Committee on Energy and Commerce
House of Representatives

The Honorable Mike Synar
House of Representatives

The Honorable Timothy E. Wirth
United States Senate

In response to your requests, this report evaluates the use of accounting controls to prevent cross-subsidization between regulated and nonregulated telephone service and addresses the resources, motivation, and authority of the Federal Communications Commission to police the behavior of the telephone companies if and when they enter new competitive businesses.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Chairman, Federal Communications Commission; interested congressional committees and subcommittees; and individual members of the Congress, as well as other interested parties. Copies will be made available to others upon request.

A list of major contributors to this report is included in appendix III.

J. Dexter Peach

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

Advances in technology, as well as industry deregulation and restructuring, have resulted in telephone companies seeking to offer competitive telecommuncations services in conjunction with their regulated services. The Congress and telephone industry regulators are currently faced with deciding how best to bring new services to the public. Both telephone companies and users can potentially benefit from new competitive services. However, without adequate safeguards and regulatory oversight to ensure that costs are properly allocated, local telephone customers risk subsidizing the competitive services (cross-subsidy) through their telephone bills.

The Federal Communications Commission (FCC) decided in 1986 to permit greater integration of competitive and regulated operations as long as prescribed cost allocation standards and procedures are followed. Congressional requesters asked GAO for information on the background and rationale for FCC's actions, as well as FCC's ability to implement the cost allocation procedures to control cross-subsidy between companies' regulated operations and their competitive ventures, which are nonregulated.

Background

In a series of decisions since 1971, FCC has dealt with the increasing convergence of computer and telecommunications technology by delineating "basic" regulated services and "enhanced" nonregulated services, and setting the conditions under which telephone companies could offer enhanced services using the regulated telephone network. FCC has generally required telephone companies to offer such services through a structurally separate subsidiary, to protect telephone customers from helping to pay the costs of competitive activities and protect competitors from unfair competition.

In 1986, however, FCC determined that separate subsidiaries were both inefficient and restricted the advance of technology. It adopted a new program of nonstructural safeguards to promote technology and efficient network use, while still addressing ratepayer and competitive concerns. A key nonstructural safeguard that FCC adopted is a process for allocating telephone company costs shared by both regulated and nonregulated operations. Elements of this process include (1) cost allocation standards and accounting procedures, (2) company cost allocation manuals, and (3) annual certified public accountant (CPA) reports attesting that the allocations accurately reflect procedures in the cost manuals. FCC will oversee the entire process and use its own auditors to periodically examine the cost allocations.

Overlying the FCC's efforts to accommodate the integration of regulated and competitive services is the U. S. district court's review of line-of-business restrictions on the seven regional Bell Operating Companies set by the 1984 Consent Decree breaking up the American Telephone and Telegraph Company. The court's September 1987 decision partially relaxed some of the restrictions, meaning some additional integration of regulated and competitive services is likely, although not as much as FCC, the Bell Operating Companies, and others had wanted.

Results in Brief

FCC's actions in prescribing cost allocation standards and requiring cost manuals and annual independent audits are all essential steps of an oversight program to ensure that telephone rates are not subsidizing competitive ventures. FCC expects these measures to provide assurance to the public that its rules and procedures are being followed consistently and that cost allocations are documented and accurately presented.

However, the unavoidably subjective nature of the cost allocation process and FCC's "public interest" mandate require that it remain involved in overseeing the allocation process and ultimately deciding whether the companies' results are acceptable. FCC plans to audit company records periodically, but at existing staffing levels these audits will be infrequent.

The level of oversight FCC is prepared to provide will not, in GAO's opinion, provide telephone ratepayers or competitors positive assurance that FCC cost allocation rules and procedures are properly controlling cross-subsidy.

Principal Findings

Past Allocation Difficulties

FCC's past cost allocation efforts have been difficult and time-consuming. Reasons for these difficulties include the lack of systematic cost allocation standards and procedures, and the inherent subjectivity, and thus arbitrary nature of the cost allocation process as applied to telephone services sharing common equipment. Economics and accounting both provide guidance on allocating costs, but do not prescribe one single "right" way. Consequently, disagreement is understandable among the affected industry and consumer interests, making it difficult for FCC to arrive at a consensus. In the past FCC justified its requirement for separate subsidiaries by citing the "inherent difficulties" in allocating costs.

FCC's New Regulatory Approach

FCC eliminated the separate subsidiary requirement because it impeded companies from offering new services and therefore imposed costs on the public. FCC determined that these costs exceeded the benefits that separation had provided by preventing cross-subsidy and other competitive abuses. Still, FCC recognized that some regulatory controls were needed to prevent telephone companies from subsidizing their nonregulated services with regulated revenues or using their control over regulated services to discriminate against competitors.

FCC's new cost allocation program attempts to overcome past problems by developing objective criteria—allocation procedures and cost manuals—to assess compliance. In addition, as a principal oversight tool, FCC is relying heavily on annual reports by CPAS attesting that a company's implementation of cost allocation follows FCC's rules. These reports should help ensure particularly that documentation is adequate and procedures are consistently applied. However, the difficulty in allocating costs of services sharing common facilities and personnel, particularly switching equipment, along with FCC's mandate to determine that regulated telephone rates are "just and reasonable," require ultimately that FCC exercise its own judgment that the telephone company costs are properly allocated.

Limited FCC Oversight

To make these judgments, FCC's periodic audits of telephone companies are crucial, particularly over the next few years, when gaining public acceptance is important. Other means of oversight—including a new computerized data base and access to the CPAS' workpapers—are also important as indicators of potential problems that may require FCC to examine company records. FCC will have access to company books and records, and plans to conduct its own audits, but at its existing level of staff and travel resources, these audits will be infrequent. Further, its fiscal year 1988 budget request proposed eliminating 3 of its 15 auditors.

Recommendation

GAO recommends that FCC develop a strategy for providing greater oversight of telephone companies' cost allocations. The key to the strategy is FCC's commitment to allocate sufficient audit staffing and travel funds to permit added field audits.

Agency Comments

As directed by the requesters, GAO did not obtain official agency comments on a draft of this report. However, GAO discussed the factual information in the report with FCC officials during the course of the work and incorporated their views as appropriate. FCC officials noted that, for the past 2 years, they had requested additional auditors, but that the requests had not survived the budget review process after submission to the Office of Management and Budget.

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Abbreviations

ARMIS	Automated Reporting and Management Information System
AT&T	American Telephone and Telegraph Company
BOC	Bell Operating Company
CEI	Comparably Efficient Interconnection
CPA	certified public accountant
CPE	customer premises equipment
FCC	Federal Communications Commission
FDC	fully distributed costing
GAO	General Accounting Office
GTE	General Telephone and Electronics
NARUC	National Association of Regulatory Utility Commissioners
OMB	Office of Management and Budget
ONA	Open Network Architecture
USOA	Uniform System of Accounts

Introduction

Over the past 2 decades, advances in technology have increasingly brought about a merging of the nonregulated data processing and the traditionally regulated telecommunications fields. This technological change, along with continuing deregulation in the telephone industry, and the Consent Decree[1] that broke up the American Telephone and Telegraph Company (AT&T) and created the seven regional Bell Operating Companies[2] (BOCs), has led to the diversification of these companies into many competitive areas. Both the companies and telephone users could potentially benefit from the use of the telephone network to provide new nonregulated competitive telecommunications services. However, customers of regulated telephone services risk the possibility of subsidizing the competitive services if the costs of shared services, facilities, and personnel are not properly allocated. The Federal Communications Commission (FCC) has the major responsibility in policing the line between the legitimate sharing of costs and the improper cross-subsidization of competitive businesses. This report will examine FCC's ability to implement a new program of safeguards against cross-subsidy, especially its new procedures for allocating costs among regulated and nonregulated activities.

Background

While FCC is encouraging telephone company[3] expansion into nonregulated activities by deciding to remove the requirement for structural separation for these competitive businesses, it also has the responsibility for implementing the new regulations that allow new services and competitive benefits without detriment to the telephone ratepayers.

FCC, the Department of Justice, and U.S. District Court Judge Harold H. Greene, who presided at the antitrust trial of AT&T, currently regulate the BOCs' new lines of business. The antitrust action settlement in the Consent Decree provided for the January 1, 1984, divestiture of the BOCs into the seven regional companies and set restrictions that prevent the

[1]United States v. American Telephone and Telegraph Company, 552 F. Supp. 131 (D.D.C. 1982) aff'd 460 U.S. 1001 (1983).

[2]BOCs refer to the following seven regional holding companies that now own the regulated local telephone companies divested by AT&T: Pacific Telesis Group in California and Nevada; U.S. West, Inc., in the Northwest, Mountain and Northern Plains states; Southwestern Bell Corporation; American Information Technologies Corporation (Ameritech) in the midwestern states; Bell Atlantic Corporation in the Mid-Atlantic states; Bell South Corporation; and NYNEX Corporation in New York and New England.

[3]Hereafter in this report we will refer to telephone companies as "carriers or common carriers" which are the FCC terms for the monopoly local exchange (e.g., the BOCs) and dominant long distance (i.e., AT&T) telephone companies subject to FCC's regulation.

BOCs from entering certain lines of business—providing information or long distance services and manufacturing telecommunications equipment. The restrictions were included in the Consent Decree to prevent the BOCs' potential abuse of their monopoly control over regulated telephone service by aiding their nonregulated activities to the disadvantage of competitors and consumers. A similar concern was at the heart of the antitrust case against AT&T.

The Consent Decree required the Department of Justice to review the need for the line-of-business restrictions on the third anniversary of divestiture. Justice recommended to the divestiture court in February 1987 that the restrictions on the BOCs' provision of information services and manufacturing of equipment be relaxed because in 3 years they had been outdated by the growth of competition, the advance of technology, and the potential benefit to consumers. Judge Greene reviewed the Justice recommendations, interested party comments, and testimony. He decided[4] in September 1987 to accept only part of the Justice recommendation. The decision relaxes restrictions on the BOCs' provision of only transmission of information services and on entry into nontelecommunications businesses. The order retains restrictions on manufacturing and providing long distance service.

Prior to the Justice recommendation and Judge Greene's decision to release the BOCs from part of the restrictions, the FCC had already decided to make carriers' entry into competitive businesses less burdensome with its May 1986 decision in the "Third Computer Inquiry" (Computer III).[5] Computer III is the latest in a series of FCC "inquiries" on how to regulate computer services using the regulated telephone network which will be discussed in detail in chapter 2. In Computer III, FCC has decided to eliminate the separate subsidiary requirement in favor of nonstructural safeguards,[6] including the cost allocation rules adopted by FCC in a related December 1986 decision.[7]

[4] United States v. Western Electric Co. Inc., et. al., Civil Action 82-0192, filed Sept. 10, 1987 (D.D.C.).

[5] Common Carrier Docket No. 85-229, In the matters of "Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)...," Report and Order, adopted May 15, 1986.

[6] In this report, safeguard refers to regulatory protection or barrier that is designed to prevent a practice considered to be harmful, i.e., cross-subsidy.

[7] Common Carrier Docket 86-111, In the matter of "Separation of costs of regulated telephone service from costs of nonregulated activities," Report and Order, adopted December 23, 1986.

The Debate Over the BOC Restrictions and Safeguarding Ratepayers

Removing the restrictions on the BOCs has been opposed by those who d(not wish to create seven smaller AT&Ts, each with the vertically integrated lines of business and the monopoly power of the former AT&T Bell System. However, many others would lift the restrictions if effective safeguards are available to control any cross-subsidy. They cited the competitive benefits available and the potential for many information services to be provided on the telephone network that are now too expensive or impossible to provide on a separated basis.

Both FCC and the National Telecommunications and Information Administration of the Department of Commerce have taken public positions, including filings with the divestiture court, arguing for the release of th BOCs. In both the 99th and 100th Congresses bills have been introduced that would remove some or all of the BOCs' line-of-business restrictions i appropriate telephone ratepayer safeguards were in place. One major argument of proponents for allowing BOC entry into new markets, especially manufacturing, has been to provide more competition for foreign imports, thus easing the large U.S. trade imbalance.

In his recent reconsideration of the Consent Decree restrictions, Judge Greene concluded that no significant changes were warranted in the major long distance, manufacturing and information service restrictions He found that monopoly control over the local telephone network still exists, but with the BOCs instead of AT&T. Allowing the BOCs unrestricted entry into these competitive areas while still maintaining "bottleneck" control over the local network would recreate the conditions that warranted the breakup of AT&T. Judge Greene also questioned FCC's ability to vigorously oversee the BOCs to control cross-subsidy and anticompeti tive abuses, based on reductions in FCC's resources and statements favoring deregulation.

There is substantial reason for regulators to be concerned about the cross-subsidy potential between regulated and nonregulated activities c the local telephone companies, whose annual operating revenues exceeded $84 billion in 1986.[8] Telephone companies are making substan tial investments in nonregulated activities. One trade association has charged that the BOCs lost nearly $1 billion in 1985 alone on nonregulated ventures. This figure is likely to increase with the growing divers fication efforts.

[8]This revenue does not include AT&T, which no longer owns local telephone companies, but represents all of the local telephone industry, including the BOCs and the 1,100+ independent companies

FCC has authority to regulate only the interstate activities of the telephone industry. The intrastate portion of the industry—local calls, services, and long distance within the state—is the responsibility of state regulators. Chapter 2 discusses some recent state efforts to oversee cross-subsidy in this large portion of the industry.

Definitions of Cross-Subsidy Differ

FCC referred to "cross-subsidy" in both its Computer III and Joint Cost decisions, but did not specifically define the term. In its written comments on the proposed Joint Cost rules, the Department of Justice provided its view of what cross-subsidy is and is not, stating that a cost allocation is subsidy-free if each service (and each possible group of services) is assigned no more than its stand-alone cost, and no less than its incremental cost. Justice defined "stand-alone" cost as the cost of providing the same quantity of a service in the absence of any other service, while "incremental" cost is the change in total cost that results from adding a service to an existing group of services.[9]

As we note on page 16, different cost allocation approaches can result in differing conclusions as to what constitutes "cross-subsidy." This difference in viewpoints surfaced in FCC's decision on a cost allocation methodology, as discussed in chapter 3.

Considerable Debate Over Adequacy of Safeguards

As FCC's changing regulation of telecommunications services has demonstrated, there is considerable room for debate over what safeguards will be effective and/or adequate given the competitive environment. After 6 years FCC removed the Computer II requirement of separate subsidiaries for nonregulated activities when it decided in Computer III that the following safeguards would be sufficient: (1) cost allocation procedures, (2) equal access to the network for competitors, (3) and rules on carriers' disclosure of information about their customers and future network changes.

Whether these safeguards would be adequate was the subject of much comment in the Computer III proceeding. Many commenters, especially those that would compete with the major companies, still held that only fully separated subsidiaries for the nonregulated activities would adequately safeguard telephone ratepayers from cross-subsidy and other abuses or at least would be less burdensome to enforce. Many other commenters, such as the regulated companies and FCC, contended that the

[9]Comments of the U.S. Department of Justice on Docket 86-111, June 1986, pp. 17 and 18.

requirement for the fully separate subsidiary safeguard was excessive and that it actually harmed the ratepayer because new services could not be offered and carriers were prevented from competing in certain markets.

Adequacy of safeguards was also discussed in Judge Greene's decision on the line-of-business restrictions. FCC's removal of the separate subsidiary requirement was considered a weakening of its regulations since the requirement had been an effective means of preventing cross-subsidy.

Proposed legislation would release the BOCs from some or all of the restrictions in the Consent Decree, but some bills also call upon FCC to safeguard the telephone ratepayer from cross-subsidy and the BOCs' competitors from injury. Bills introduced in the 100th Congress in 1987 to release the BOCs include:

- H. R. 2030, "Telecommunications Equipment and Information Services Act of 1987," which calls on FCC to prescribe rules to prevent cross-subsidy, spells out allocation criteria, orders FCC to insulate ratepayers from failure of competitive ventures, and would control asset transfers in the interest of ratepayers and mandate an independent audit.
- S. 209, "Telecommunications Equity Act of 1986," would release the BOCs upon a finding by FCC that entry would not harm competition and is in the public interest and directs FCC to regulate these new businesses as necessary.
- H. R. 15, the "Trade Partnership Act of 1987," would remove the manufacturing restriction only upon a Secretary of Commerce analysis, after consultation with FCC, concluding that equal access to the network has been achieved and there is no substantial possibility that BOC manufacturing would impede competition in that business.

Benefits of Sharing Costs

While FCC's cost allocation procedures attempt to control cross-subsidy and deal with the problems of sharing costs, it is also important to note the potential benefits FCC and many others foresee from carriers offering regulated and competitive services on an integrated basis. When FCC adopted the Computer III order, its Chairman spoke of these benefits. He stated,

> ". . .breaking down the wall of structural separation. . .should make new uses of the telephone network more widely available—available at costs affordable to the common man. The enhanced services marketplace can boast its Nieman Marcuses and its Rodeo Drive; I anticipate that today's decision will produce more K-Mart and Sears-

type Information Age products. . .. [W]e can herald an Age of Efficiency in the field of telecommunications that can benefit all consumers, including the lowering of local rates."[10]

Continuing in this vein, the January 1987 Department of Justice consultant's report submitted to the divestiture court stated

"Shared costs are a problem for the regulatory accountant. For everyone else they are an opportunity to gain efficiency. A [carrier's] ability to provide joint marketing and billing handles two services for the price of one. . .. Locating enhanced-service equipment on the same premises as basic-service facilities may make productive use of space opened up as compact modern digital switches and fiber-optic cable displace the older, larger systems. . .. Viewed in a positive light, costs that are shared under the umbrella of private, for-profit enterprise can mean increased productivity of both labor and capital."[11]

Objectives, Scope, and Methodology

This report addresses questions raised in two separate congressional requests. An October 7, 1986, letter from Representative Mike Synar, a member of the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, coordinated with an April 22, 1986, request by then Subcommittee Chairman Timothy E. Wirth, who had requested assistance in evaluating the use of accounting controls to prevent cross-subsidization between regulated and nonregulated activities of the BOCs. The requests have also been coordinated with the current Chairman of the Subcommittee on Telecommunications and Finance, Representative Edward J. Markey. (See app. I and II.)

Representative Synar's request raises broad questions about the resources, authority, and motivation of the FCC and state regulators for policing the behavior of the BOCs if and when they enter previously restricted businesses. As a result of discussions with Subcommittee and Representative Synar's staff, we agreed to concentrate on the background, rationale, and structure of FCC's Computer III and cost accounting controls and on FCC's ability to implement the new regulatory program. Our examination of FCC's cost accounting and allocation procedures does not constitute approval of those procedures from the perspective of GAO's statutory responsibility to approve executive agencies' accounting systems.

[10]Statement by Chairman Mark S. Fowler on Computer III, May 15, 1986, pp. 2 and 3.

[11]The Geodesic Network, 1987 Report on Competition in the Telephone Industry, Consultant's Report to the U.S. Department of Justice, Jan. 1987, p. 6.40.

Our audit work was conducted in Washington, D.C., between October 1986 and May 1987 at the FCC Common Carrier Bureau and Office of the Managing Director and at offices of various companies and trade groups interested in these issues. We interviewed officials of these organizations and reviewed extensive written documents including: comments, petitions, and decisions in the Computer III and joint cost proceedings at FCC; other FCC documents, including staff audit reports on carrier activities; and selected documents from related FCC proceedings on the Uniform System of Accounts (USOA), automated reporting, separations, access charges and Computer II. Unless otherwise specified, statements in this report attributed to FCC are taken from public notices, reports, and orders approved by action of the FCC in its various proceedings on these issues. We also reviewed the Department of Justice consultant's report on the status of competition in the telephone industry and documents filed in U. S. district court on the AT&T Consent Decree.

We performed our work in accordance with generally accepted government auditing standards. As directed by the requesters, we did not obtain official agency comments on a draft of this report. We discussed the factual information in the report with FCC officials during the course of our work and have incorporated their views as appropriate.

FCC's Uneven History of Overseeing Telephone Company Cost Allocations

FCC's experience with allocating the costs of telephone service stems from its regulatory responsibilities for:

- separating telephone service costs between state and interstate jurisdictions,
- allocating AT&T's interstate costs among its various service offerings, and
- allocating telephone company costs between its regulated and nonregulated activities, under the Computer II decision.

FCC's past efforts have been time-consuming and difficult, in part because of its case-by-case approach towards cost allocations and the arbitrary, subjective nature of the allocation process. Knowledge of FCC's experience in this area helps in understanding the issues surrounding FCC's current efforts to develop and implement a new and broader cost allocation program.

Separations Process Is Essential Part of Federal-State Regulation

The separation of costs and revenues between interstate and intrastate operations is a key element of common carrier regulation because FCC and the states each regulate telephone services within their respective jurisdictions. FCC's Separations Manual contains procedures for separating these telephone company property investments, revenues, and expenses. The basic criteria used to make the separation—the amount of usage of the telephone system in each jurisdiction—seems simple, but becomes very complicated since a telephone network is not necessarily designed with political boundaries in mind, and most telephone plant is used both for intrastate and interstate operations.

Telephone company costs are initially recorded in hundreds of categories as specified in the Separations Manual and then are apportioned between intrastate and interstate operations, either by direct assignment or through such allocation factors as "weighted standard work seconds," "holding time minutes," or "conversation minute miles." In addition, the manual is frequently revised to reflect changes in the industry and in regulatory policy, and FCC is occasionally called on to issue interpretations.

Although the Separations Manual is complex, it is only an outline of the actual separations process; and it does not provide a particularly sophisticated or accurate cost allocation system, in FCC's view. According to

FCC, the manual contains "unavoidable inaccuracies and intentional policy choices, and individual judgments," and does not assign "true" economic costs to the jurisdictions. Nonetheless, since it is an existing, long-established system, FCC considers it to be a reference point for developing other cost allocation systems. In addition, the separations process continues to be an essential part of state and federal telephone regulation. FCC has recently adopted Federal-State Joint Board[1] recommendations revising the Separations Manual to make it conform with the revised Uniform System of Accounts.

Allocation of AT&T's Interstate Costs Became Important as Competition Developed

Long before the AT&T divestiture, when telecommunications was furnished largely by regulated carriers, primarily the monopoly AT&T, FCC seldom became involved in how the carriers decided to allocate their total revenue among their regulated services. FCC considered determining rate levels for individual services to be secondary to determining the proper overall revenue requirements. However, in the mid-1960s, as AT&T began to encounter competition for some of its regulated private line services, FCC became concerned about AT&T's allocation of costs among its services. An AT&T study prepared for FCC in 1965 showed large differences among the rates of return earned by AT&T's services, raising the possibility that services subject to the most competition were subsidized by others.

Subsequently, FCC investigated all of AT&T's rates and services, and in 1969 issued its Statement of Ratemaking Principles and Factors. The study recognized two different costing approaches, fully distributed costing and long-run incremental costing, each with a different view of what constitutes cross-subsidy. AT&T preferred the incremental method with a "burden test," under which a new service was judged not to be cross-subsidized by existing services if the additional "marginal" revenue generated exceeded the cost of offering the new service. FCC staff supported the fully distributed method with an "equality of return" test, whereby overall carrier costs were equitably distributed to all service offerings, and cross-subsidy resulted when a service earned less than the average overall rate of return.

In 1968 FCC initiated a review of all of AT&T's private line service tariffs, considering how theories of marginal costing and pricing might be

[1]The Joint Board, provided for under Section 410 of the Communications Act of 1934, is composed of three FCC Commissioners and four state public utility commissioners. Set up as needed by FCC, the board deals with regulatory issues of concern to both federal and state authorities, e.g., jurisdictional separations.

applied to firms conducting both monopolized and competitive activities. FCC considered seven fully distributed costing methodologies and ultimately adopted a modification of one that was designed to cover the full recorded costs of operations.

FCC concluded its lengthy review in 1976 but never succeeded in using its preferred cost allocation method to determine lawful rates for AT&T's services. This was due in part, an FCC decision stated, to the massive and complex data generated by AT&T's costing procedures. Faced with the need to develop manageable cost allocation rules, FCC did develop and implement an interim cost allocation manual in 1981, which is still in effect.

As competition has grown since then, FCC in several instances allowed AT&T greater pricing flexibility than could usually be achieved with fully distributed costing. It allowed AT&T to offer discounts to large users of private line services in order to meet the competition from unregulated providers. It also departed from its fully distributed cost guidelines in allowing AT&T to offer discount long distance packages if AT&T could show that net long distance revenues would increase as a result.

Separation of Regulated and Nonregulated Costs Increases in Importance

Telephone companies have always engaged in a certain amount of incidental nonregulated activity, but regulators were not concerned about cost shifting because the activities were usually very small and closely related to regulated activities. However, with advances in telecommunications technology and the merging of the data processing and telecommunications fields, telephone companies have increasingly sought to compete in nonregulated markets.

Separate Subsidiaries vs. Accounting Separation

FCC's response to this desire by carriers to enter nonregulated markets has been to use both structurally separate subsidiaries and accounting separation as means of controlling any attempt to shift costs from nonregulated to regulated activities. Under structural separation a carrier conducts any nonregulated business in a subsidiary separate from its regulated telephone operations. In its most extreme form, structural separation would prohibit any common costs, i.e., the regulated and nonregulated activities would not share space, equipment, personnel, or services. The carrier could invest capital into the separate subsidiary to get it started, but then the subsidiary would be on its own. Regulated operations would not be affected except to the extent that the nonregulated business grew large enough to affect the overall company's cost of capital. FCC has never required structural separation in this extreme form, nor has FCC required separation for all companies, or for all nonregulated activities.

With accounting separation, a carrier can conduct nonregulated activities without setting up a subsidiary but would be required to keep separate accounting records to track nonregulated revenues and expenses. These accounting controls provide the means to determine that the carrier's regulated telephone rates are not affected.

FCC Policy Evolves in "Computer Inquiries"

FCC's initial regulatory response to the movement of telephone companies into nonregulated, computer-related services was its First Computer Inquiry (Computer I), initiated in 1966. FCC decided in Computer I not to regulate data processing services, but required carriers providing such services to do so through separate corporate subsidiaries.[2] The subsidiaries had to maintain their own financial records, have separate officers, and use separate personnel, computer equipment, and facilities for their data processing services. Thus, Computer I controlled cost shifting by prohibiting any joint costs in the form of combined operations and marketing. Computer I did permit separate subsidiaries the efficiencies of sharing administrative and corporate overhead expenses.

As advances in technology made it more difficult to distinguish between "data processing" and "communications," FCC initiated its Second Computer Inquiry (Computer II) in 1976. The Computer II decision created a regulatory distinction between "basic" and "enhanced" services.[3] It deregulated enhanced services as well as customer premises equipment

[2]FCC did not apply Computer I to AT&T since it assumed AT&T was barred from offering these services by the 1956 Consent Decree, United States v. Western Electric, 13 RR 2143, 1956 Trade Cas. 71,134 (D.N.J. 1956).

[3]FCC defines basic services as traditional common carrier offerings of transmission services for the movement of information. Enhanced services are those, offered over common carrier transmission facilities, that use computer processing applications acting on the format, content, code, protocol, or similar aspects of the subscriber's transmitted information; provide additional, different, or restructured information; or involve subscriber interaction with stored information.

(CPE).[4] FCC decided that the enhanced service and CPE markets were competitive, making regulation unnecessary, but required that carriers offer these services through separate subsidiaries.

Structural Separation as Applied Under Computer II

FCC was concerned that those carriers able, under Computer II, to offer nonregulated enhanced services and CPE could use their control over regulated telephone services to discriminate against competitors. FCC was also concerned that carriers could misallocate costs from nonregulated to regulated activities, imposing an unfair burden on ratepayers, and cross-subsidize their competitive offerings. Therefore, both to maximize consumer benefits by promoting competition in the enhanced and CPE markets and to control any abuses, FCC's Computer II decision required structurally separate subsidiaries.

In requiring separate subsidiaries, FCC did not expect that companies would have less incentive to cross-subsidize their nonregulated activities. FCC did believe, however, that structural separation would make competitive abuses easier to detect and thus more difficult to accomplish. Under structural separation transactions between the regulated and nonregulated entities have to be recorded in the separate records of both businesses.

In deciding which carriers would be subject to the structural separation, FCC had to assess whether separation offered competitive and ratepayer benefits outweighing the carriers' cost of compliance. FCC decided to impose structural separation requirements only on AT&T,[5] allowing all other carriers to rely on separate accounting records to keep track of their costs for CPE and enhanced services.

Cost Allocation Requirements Under Computer II

The Computer II decision contained several provisions designed to ensure proper allocation of certain costs between the regulated and nonregulated operations. Structural separation prohibited AT&T from sharing activities in such areas as telephone operations and marketing, judged to be susceptible to significant cost misallocation. FCC did permit, however, certain activities to be shared. For example, administrative

[4]Customer premises equipment are devices, ranging from simple telephones to computers, that are located on the customer's premises and are used to send or receive information over the telephone network.

[5]FCC's decision also applied structural separation to General Telephone and Telegraph (GTE), but FCC later reconsidered and concluded that the costs of separation on GTE outweighed its benefits.

services could be shared by nonregulated and regulated entities, subject to FCC approval of accounting and cost allocation plans.

For those carriers not subject to the separate subsidiary requirement, FCC had also intended to establish cost allocation rules for distributing shared expenses and common investment, but ultimately deferred a decision to its joint cost proceeding developed with Computer III. In the interim, however, FCC instructed those carriers to use a fully distributed costing methodology to allocate costs to nonregulated activities.

An additional Computer II condition concerned nonregulated subsidiaries using telephone services of the regulated parent carrier. Since the provision of enhanced services necessarily involves using the carrier's regulated network, FCC required that the subsidiaries pay the same price for using network services that the carrier's other customers would have to pay.

Computer II Safeguards Applied to the New BOCs

After the January 1984 AT&T divestiture, an FCC decision concluded that the structural separation requirements it had imposed on AT&T should also apply to the seven newly formed BOCs. However, FCC did not apply the full range of separation requirements originally imposed on AT&T. FCC allowed the BOCs to carry out limited joint operations, including (1) CPE billing, (2) installation and maintenance of residential and single-line business telephones, and (3) sharing administrative services.

At that time, FCC discussed the eventual removal of the remaining structural separation requirements but noted that they were needed for the time being. FCC stated that nonstructural safeguards may adequately protect the public interest at some future time. However, FCC found that the costs to keep CPE operations structurally separate were not substantial, because combining CPE with regulated telephone services created few economies. FCC concluded that the costs to the BOCs of requiring structural separation were outweighed by the benefits, but indicated that it would reexamine this balance within 2 years.

Waiver Requests Require Cost Allocation Plans

After its Computer II decision, FCC stated it would accept carrier requests for waivers or clarification of the structural separation rules. FCC considered waivers for particular services if the requester could show that structural separation imposed unreasonable costs on consumers or made the particular service uneconomic. FCC approved a number of waivers, including (1) allowing AT&T to temporarily provide installation and maintenance service to its nonregulated subsidiary that sold business CPE services and (2) allowing the BOCs to provide an enhanced service, called protocol conversion, using computers collocated with the BOCs' telephone switching equipment. A condition of each waiver was FCC's acceptance of the carrier's cost allocation plan for each service.

FCC's Oversight of Past Cost Allocation Plans

FCC has relied on several mechanisms to oversee the cost allocation processes followed by carriers in the past, including review and approval of cost allocation plans, requiring a report by an independent accountant, and FCC audits of the actual allocations.

One other means of oversight is by audits of carriers' intrastate operations by state public utility commissions that also are concerned about potential cross-subsidy between regulated and nonregulated operations. FCC auditors review state audit results as part of their own carrier audits.

FCC Review Process Varies on a Case-By-Case Basis

FCC has generally required an approved accounting and allocation plan before allowing a carrier to share costs between regulated and nonregulated operations. The plans explain how shared costs would be allocated between the regulated and nonregulated operations.

The FCC approval process has involved several different steps, as needed, including (1) FCC staff review of the plans, (2) obtaining public comments on the proposals, (3) review of the plan by a certified public accountant (CPA), and (4) FCC staff examination of the supporting documentation. FCC has not used all of these review steps for each plan, making determinations on a case-by-case basis.

FCC Audits Have Been an Important Element of Past Oversight

While the preceding review steps occur prior to FCC approval of the allocation plans, FCC has also used its own staff to regularly audit their implementation. An FCC Audits Branch official said their audits have not generally discovered major problems with the way the carriers allocated their costs. As a rule the problems identified were administrative or technical in nature and were resolved by the FCC staff rather than being brought to the attention of the FCC Commissioners for action.

FCC has a small audit staff, which, combined with limited travel funds for on-site visits, is not able to audit all operations of each carrier annually. In addition, the audit staff has additional audit responsibilities, for example, the separations process and access costs billed to long-distance carriers by the local carriers for use of the local telephone network.

An Audits Branch official said that an audit generally involves three auditors and that each auditor could work on four audits per year unless assigned to other duties like FCC or Joint Board proceedings. The audit team generally first schedules a 1-week survey visit to the carrier to collect data and plan the detailed audit work. The on-site audit then occurs during a later 2-week visit to the carrier headquarters and possibly other locations. The number of audits performed and time spent at each location is tied not only to available staffing, but also to the travel budget.

An Audits Branch official said the carriers have been cooperative in providing information FCC auditors have needed. He said no data request has been ultimately refused by a carrier, even for information on unregulated activities. The resulting reports are used internally by FCC and are not released to the company audited or to the public.

To get a firsthand look at the results of a cross-section of FCC staff audits, we reviewed 11 audit reports and summaries prepared during 1984-1986, covering a variety of activities in each BOC and in a General Telephone and Electronics (GTE) operating company. The areas audited in the reports we examined included cost allocations, separations, access charges, and sharing of administrative services between regulated and nonregulated subsidiaries. Our review confirmed what Audits Branch officials had told us about the nature of the findings and absence of evidence of major cost misallocations.

The recommendations, contained in 8 of the 11 reports, were normally addressed to other FCC offices or to the Commission itself. An Audits Branch official said that recommendations are not made directly to the carriers because FCC would have to approve them as a Commission order. The official noted, however, that when an audit finds a clear violation of a rule, the staff communicates directly with the carrier either verbally or in writing. Corrective actions are usually incorporated into an appropriate Commission proceeding.

For example, previous recommendations regarding joint costs were incorporated into the joint cost proceeding or will be considered as the staff reviews the cost allocation manuals submitted by the carriers. FCC Audits Branch staff cited two instances in which an FCC audit resulted in a formal, public FCC staff action. One was a 1984 letter to carriers clarifying procedures in the separations manual and the other a March 1987 letter to four carriers on separations treatment of BOCs' sales agency commissions.

State Audits

State public utility commissions also have concerns about intrastate telephone revenues being used to subsidize carriers' nonregulated activities. In 1984 the National Association of Regulatory Utility Commissioners (NARUC)[6] initiated audits by state public utility commission staffs of the intrastate operations of each of the seven regional BOCs. NARUC was concerned that the regulated telephone companies were subsidizing the holding companies' nonregulated subsidiaries and that regulators would not be given access to the holding company records to monitor nonregulated activities.

The ensuing audits, released during 1986 and 1987, generally described the organizational structures of the holding companies, raising regulatory concerns about the potential for cross-subsidy. However, most of the audits did not examine records in detail in an attempt to find actual instances of cross-subsidy. NARUC issued a summary report citing the following common concerns: (1) access to records of nonregulated operations, (2) the effect on the ratepayer of using profits from regulated operations and/or borrowing to finance nonregulated ventures, and (3) moving profitable services from regulated to nonregulated control.[7]

The California Public Utilities Commission audit of Pacific Telesis was more extensive than other audits in that it examined financial and accounting records for evidence of cross-subsidy, and found a number of problems. Deficiencies reported by the audit included the following:

- Pacific Telesis' regulated operations served as a talent pool, with employees transferred or loaned to nonregulatory operations without adequate compensation to Pacific Bell.

[6]NARUC is a quasi-governmental, nonprofit organization whose members include regulatory bodies of the 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

[7]NARUC's September 1986 report summarized the audits of Ameritech, Bell Atlantic, Bell South, Pacific Telesis, and U.S. West. Southwestern Bell was not audited, but the Oklahoma Corporation Commission considered the audit results on U.S. West to also be applicable to Southwestern Bell. An audit of NYNEX was not completed and released until March 1987

- Properties were transferred to nonregulated operations below their fair market value or services were provided at no charge.
- Nonregulated operations received intangible benefits, such as Pacific Bell's reputation, from their association with the regulated operations.

One novel recommendation made in the report was that Pacific Telesis' nonregulated operations make royalty payments to Pacific Bell, the regulated entity, in compensation for the benefits received from their affiliation with Pacific Bell.

FCC's Past Difficulties in Implementing Its Cost Allocation Policies

FCC's implementation of its various cost allocation policies has been difficult and time-consuming. In a number of instances, FCC has done lengthy reviews before approving carriers' cost allocation plans, and in one case was never able to complete its planned action. FCC's revision of its Uniform System of Accounts, which provides the framework for a cost allocation system, has also been delayed. Among the reasons for these difficulties are the lack of systematic FCC cost allocation standards and procedures and the inherent subjectivity, and thus arbitrary nature, of the cost allocation process as it is applied to telephone services sharing common equipment.

Allocating AT&T's Costs: A Lengthy Exercise

FCC's effort to allocate costs among AT&T's various regulated services, as discussed earlier in this chapter, is an extreme example of the difficulty FCC has had in implementing its cost allocations policies. The exercise extended from 1965 to 1981. First, AT&T and the FCC staff disagreed over basic costing approaches—incremental vs. fully distributed costing. Then, when the FCC staff presented seven fully distributed costing methodologies for the Commission's consideration, it disagreed with the staff's recommended decision. FCC finally approved a methodology in 1976, but then AT&T was unable to develop a costing manual satisfactory to FCC. In 1981 FCC approved an interim cost allocation manual for AT&T, which is still in effect. The interim manual is not very detailed, allocating costs only among four broad service categories without further allocating costs among specific services in the four categories.

FCC's review of AT&T's allocation plan for providing CPE services without structural separation is another example of FCC's lengthy approval process. After FCC proposed, in February 1985, to free AT&T from having to provide CPE through a separate subsidiary, AT&T proposed a plan conforming to existing FCC accounting and allocation guidance. FCC determined it needed more information and, in September 1985, ordered AT&T

to submit a new, more detailed plan. In November FCC approved the detailed plan on an interim basis but also solicited public comments and started a more detailed review. An FCC order extended its interim approval in July 1986 but sought clarification and additional information from AT&T. FCC required quarterly data filings by AT&T until the interim plan was superceded by the new allocation rules in the joint cost proceeding. (See ch. 3.)

Revising the Uniform System of Accounts Took 8 Years

FCC began revising its 1935 Uniform System of Accounts (USOA) in June 1978. Finally issued in May 1986, the revision is scheduled to take effect in January 1988. Contributing to the time required to revise the USOA was disagreement over whether the new USOA should incorporate costing data.

The USOA provides a means for classifying, recording, interpreting, and reporting a carrier's financial information and is a fundamental source of information for FCC. Adopted by FCC when its basic concern was the overall financial results of the regulated carriers, the USOA provides data on overall investment and expense levels, property valuation, and depreciation rates. The USOA is also used for reviewing carriers' overall revenue requirements, including determining a fair rate of return.

Technological change, which created new means of providing telecommunications services not reflected in the accounts, caused the need to revise the USOA. For example, USOA account categories did not recognize use of microwave and satellite facilities for long distance communications. This same technological change created a variety of new competitive services and created an incentive for carriers to cross-subsidize services. Thus, FCC was concerned with the costs and rates for individual services, but the USOA was little help because it focused on company-wide results rather than individual services.

FCC's objective when beginning the revision was that the new USOA would be a single database serving several functions, including cost and revenue data for individual services. Comments FCC received on the proposal contended that such a broad system would be too costly and complex to implement and administer. In October 1981 FCC backed away from its single database approach and proposed that the USOA not include a cost accounting system but be designed to interrelate with cost allocation procedures to be developed later. FCC also established an industry advisory group—a mixture of telecommunications, regulatory, accounting, and consumer interests—to prepare a proposal for a revised USOA.

FCC staff and the advisory group differed among themselves as to whether the new USOA should include cost accounting and pricing data. On the basis of the work of the advisory group, the revised USOA that FCC proposed in December 1984 did not address the allocation of costs attributable to nonregulated services. However, the advisory group did prepare a report to FCC entitled, Determination of Nonregulated Costs in Regulated Entities, which FCC used in developing its joint cost proceeding. FCC ultimately approved its revised USOA in May 1986.

FCC's Ad Hoc Approach and the Arbitrary Nature of Cost Allocations Cause Problems

FCC has stated that its past problems in providing cost allocation guidance to carriers resulted from its ad hoc case-by-case approach toward controlling cross-subsidy. Another fundamental problem is the subjective and arbitrary nature of allocating costs of services that share the same equipment. Therefore, there is likely to be disagreement over how "best" to allocate these costs.

When FCC released, for public comment, its proposed new cost allocatior procedures in the joint cost proceeding, it noted that its past case-by-case reactive approach toward allocating costs of nonregulated activitie was a "time consuming, expensive, and uncertain process." FCC said tha this approach was appropriate given its lack of experience, but realized that it did not provide much in the way of positive guidance to carriers. Its only substantive standard was the requirement that nonregulated activities carry their fully distributed costs.

As we discuss in more detail in chapter 3, the economic and accounting disciplines provide guidance on allocating costs common to several telecommunications services, but they do not prescribe a single "right" wa. Consequently, any allocation method chosen can be considered arbitrary. A 1985 telecommunications study by the California Public Utilit Commission echoes this point in stating that "What it costs to provide telephone service is a frequently asked question that has never been answered to the satisfaction of all interested parties." The study also pointed out that "The appropriateness of an [costing and pricing] optic depends on the Commission's goals. Various methods will perform differently relative to promoting economic efficiency and equity."[8]

[8]Charting A Sustainable Regulatory Course in Telecommunications, California Public Utilities Commission, Oct. 1985, p. C-2.

The Department of Justice's consultant's report on competition in the telephone industry, submitted to the divestiture court, stated that "Allocating truly common costs among the activities they support is a mysterious and fundamentally arbitrary process."[9] FCC's 1980 Computer II proceeding also agreed that there were problems in establishing a rational and effective cost allocation scheme, and therefore prohibited joint activities in enhanced service areas "Because of the inherent difficulties in allocating joint and common costs. . .."

Given the leeway possible in the choice of an allocation method, disagreement among various affected telephone and consumer interests on the appropriate method is understandable. It is no surprise, therefore, that FCC would have difficulty weighing these competing interests to select an appropriate method in the "public interest."

[9]The Geodesic Network, 1987 Report on Competition in the Telephone Industry, Consultant's Report to the U.S. Department of Justice, Jan. 1987, p. 6.38.

Proper Implementation of Joint Cost Rules Is Key to Preventing Cross-Subsidy

In December 1986, FCC approved its joint cost decision, establishing cost allocation standards and procedures for carriers to follow in providing allowable nonregulated services. FCC's ability to implement its joint cost rules is a key element in the ultimate success or failure of its new regulatory approach—to promote advances in technology while still preventing carriers from subsidizing their nonregulated competitive ventures from regulated telephone revenues. FCC must implement these rules, coordinate them with other related FCC initiatives, and automate the reporting and analysis of data involved all in a short period of time.

Chapter 3 outlines the major features of FCC's new regulatory program, explaining the rationale and expectations behind important provisions, as well as their status and implementation timetable.

The Third Computer Inquiry Advances a New Regulatory Approach

FCC's Third Computer Inquiry decision (Computer III) was the foundation for its subsequent joint cost proceeding. FCC adopted Computer III ir May 1986, in recognition of continuing advances in technology and the changing telecommunications marketplace. In Computer III, FCC found that significant efficiencies may occur in permitting carriers to combine their regulated and nonregulated activities, and that it is in the public interest to allow them to achieve these efficiencies. The offering of new nonregulated services over the regulated telephone network could lead to more efficient use of the network, benefitting all telephone users.

Specifically, the Computer III decision permits carriers to offer nonregu lated telecommunications services without having to first set up a separate subsidiary. In reaching its decision, FCC concluded that requiring separate subsidiaries impeded carriers from offering new nonregulated services, and thus imposed costs on the public because such services ar not available. FCC determined that these costs exceeded the benefits tha separation provided in preventing cross-subsidy and other competitive abuses. FCC recognized, however, that the potential for cross-subsidy and competitive abuses still existed and needed to be addressed. Thus, FCC also established nonstructural safeguards in Computer III and its subsequent joint cost decision.

Computer III Relies on Nonstructural Safeguards

While concluding that the costs of imposing structural separation exceeded the benefits, FCC's Computer III decision recognized that som regulatory controls were still needed to prevent carriers offering nonr ulated services from subsidizing these services with regulated revenue or using their control over their basic regulated services to discriminat against competitors. FCC, therefore, required that the carriers comply with the following conditions when offering nonregulated telecommunications services on an unseparated basis.

- Carriers using their regulated network to provide nonregulated services must also allow competitors equal access to the network to provide competing services.
- Carriers must disclose information to competitors about their regulated customers and future changes in the regulated network, since they could otherwise use this information for unfair advantages over competitors.
- Carriers must comply with detailed cost accounting procedures.

To achieve its equal access objective, FCC created two new regulatory concepts, "Comparably Efficient Interconnection" (CEI), and "Open Network Architecture" (ONA), to prescribe how this access is to be achieved on a nondiscriminatory basis. The FCC decision stated that the CEI requirements were designed to control carriers from discriminating against firms seeking to compete with them in providing nonregulated services. Accordingly, the CEI provisions require that carriers provide competitors with basic regulated telephone services that are technically equivalent and comparable in price to those services they use for their own nonregulated service offerings. ONA, a broader concept than CEI, involves the overall design of a carrier's basic regulated network to permit all users of the network, including competitors and the carrier's own nonregulated services, to interconnect with basic network functions on an equal-access basis.

Computer III set forth the requirement for cost accounting rules, but deferred to the joint cost proceeding the development of specific procedures for allocating joint and common costs between companies' regulated and nonregulated services provided without separate subsidiaries. In its decision, FCC observed that the cost allocation procedures and ONA are the two key elements of long-term regulation of nonregulated services provided by carriers in the absence of separate subsidiaries.

FCC's Joint Cost Decision Sets Allocation Standards and Procedures

FCC's joint cost decision adopted standards for carriers to follow in separating the costs of regulated telephone service from costs of their nonregulated lines of business. The joint cost decision set up an overall program, including

- cost allocation standards, adopting a fully distributed costing methodology;

- requirements for cost allocation manuals;
- rules for recording transactions between regulated carriers and their corporate affiliates; and
- accounting procedures, audit requirements, and other implementation and enforcement mechanisms.

FCC's overall goal in the joint cost proceeding was to ensure the "just and reasonable" telephone rates, called for in the Communications Act of 1934, requiring that carriers' regulated services be safeguarded from subsidization of its nonregulated ventures. FCC stated that cross-subsidy could result either from misallocation of joint costs or from improper pricing of services and assets provided by one affiliate to another within the carrier's corporation. FCC had broadened the factors contributing to "just and reasonable" rates, in light of its rationale for Computer III, to include savings that might accrue to the ratepayers from integrating regulated and nonregulated operations. In this regard, FCC's goal for the joint cost rules included maximizing the availability of efficient, low-cost, telecommunications services.

FCC Chooses Fully Distributed Costing Methodology

In the joint cost proceeding, FCC chose fully distributed costing (FDC) as the appropriate methodology for allocating joint costs among a carrier's regulated and nonregulated activities. Under the FDC methodology, the entire cost of a group of products is divided by first assigning those costs directly associated with each product or service and then assigning any joint or common costs on some pro-rata sharing method. FCC's intent was to emphasize the direct assignment of costs by determining what caused the costs to be incurred, thereby minimizing the need for pro-rata allocation formulas. FCC stated that it selected FDC on the basis of its past use (1) in the separations process and (2) in allocating costs among AT&T's regulated services. (See ch. 2.)

In selecting FDC, FCC rejected an incremental or marginal costing methodology whereby only the additional costs created by producing the product or service would be assigned. In principle, economic efficiency is advanced when price, which measures the value of an incremental unit of output to consumers, is equal to marginal cost, which reflects the value of the resources to produce that incremental unit of output. Under an incremental costing approach, however, it is possible that all common costs could be assigned to regulated activities since the marginal costs associated with new nonregulated ventures would be low, given the set of other services the carrier is already usually providing. In addition, an incremental cost approach has been viewed as too complicated or impractical to implement. For example, in its comments to FCC concerning the joint cost proceeding, the Department of Justice defended the use of FDC on practical grounds, stating that "...it will be difficult to identify and quantify all incremental costs of nonregulated activities...."[1]

Proponents of marginal costing argued in comments to FCC that FDC arbitrarily assigns costs to nonregulated activities regardless of whether the nonregulated activities caused the costs. Specifically, some BOCs expressed concern that use of FDC would require them to forego offering a service if its market price is less than the FDC costs, yet greater than the long-run marginal costs. Some economists have stated that, under FDC pricing, common costs are allocated in a manner that "has no claim to economic efficiency and is to a large degree arbitrary."[2] In addition, some critics of FDC have specifically stated that an FDC methodology does not allocate common costs in such a way that cross-subsidies are necessarily eliminated.[3]

FCC said its choice of FDC over marginal cost allocation was not only to avoid cross-subsidy but also to achieve the Communications Act goal of "just and reasonable" treatment of the ratepayer. This requires that ratepayers participate in economies of scale and scope[4] that FCC believes will come from integrating nonregulated services within the basic telephone service network. FCC said it was seeking to promote an equitable sharing of common costs between regulated and nonregulated activities and did not agree with commenters who took extreme approaches to the allocation of common costs. Specifically, some commenters to FCC believed that all common costs should be assigned to regulated businesses, while others believed all of these costs should be assigned to nonregulated businesses. In this regard, the Department of Justice stated that, given the telephone companies' "...incentives to engage in cross-subsidization, we submit that it is better to require nonregulated activities to bear a share of what appear to be common costs than to

[1] Reply comments of the U.S. Department of Justice on Docket 86-111, July 1986, p. 8.

[2] The Theory of Public Utility Pricing, S. Brown and D. Sibley, Cambridge University Press, 1986, p. 60.

[3] Ibid., p. 49.

[4] Economies of scale exist when the average cost of a service declines as the total level of the service provided increases. Economies of scope exist when two or more services can be provided at a lower cost than if these services were provided separately.

require regulated activities to bear all costs that are not identifiable as incremental costs of nonregulated activities."[5]

As a final point, FCC also noted that its cost allocation rules do not regulate the selling price of nonregulated services, leaving to the business judgment of the carrier how best to recover (or not to recover) its costs.

The Cost Allocation Standards Emphasize Direct Assignment

The cost allocation standards FCC adopted reflect its preference for the FDC methodology. Its approach is consistent with comments by some public accounting firms and also incorporates suggestions from one of our prior reports[6] on FCC's cost allocation efforts.

FCC stated, in the joint cost proceeding, that costs were to be directly assigned either to regulated or nonregulated activities to the maximum extent possible, with the remaining costs allocated using direct or indirect measures of cost causation. The specific costing standards adopted were as follows:

(1) Nonregulated services will pay for any tariffed[7] (regulated) services they use at the tariffed rate.

(2) Whenever possible, costs will be directly assigned to either regulated or nonregulated activities. For example, the cost of equipment purchased solely to provide regulated or nonregulated services will be allocated accordingly.

(3) Costs that cannot be directly assigned are called common costs and are grouped into categories and allocated between regulated and nonregulated activities according to the following hierarchy:

- Whenever possible, the cost will be allocated based on direct analysis of the origin of the costs themselves. For example, an objective and verifiable measure for allocating the cost of machinery might be by hours of use for regulated and nonregulated purposes.
- When direct analysis is not possible, the allocation will be based on an indirect linkage to another cost category for which a direct assignment

[5]Reply comments of the U.S. Department of Justice on Docket 86-111, July 1986, p. 8.

[6]Status of FCC Efforts To Allocate Costs Between Telephone Companies' Regulated and Unregulated Activities (GAO/RCED-83-235, Sept. 2, 1983).

[7]A tariff is a statement filed by a carrier with a state or federal regulatory agency describing a publically available service, a schedule of conditions, and the charges for the service.

allocation is available. For example, the number of purchase orders processed might be an appropriate measure of allocating the cost of the purchasing department.

- when no direct or indirect allocators are available, the costs will be allocated on the basis of a general allocator computed using the ratio of all expenses directly assigned to either the regulated or nonregulated activities. This category includes such items as general administrative expenses not easily related to specific regulated or nonregulated activities.

(4) Investment in plant and equipment used by both regulated and nonregulated activities shall be allocated on the basis of the highest forecast relative use over the life of the investment. This ensures that the regulated rate base will not absorb the cost of equipment purchased for future nonregulated use or if the future nonregulated use does not materialize.

FCC expects the amount of costs to be allocated by a general allocator, as in the third alternative in the allocation hierarchy described previously, to be low. FCC's decision stated that with a well-designed cost allocation manual, each carrier can assign a very high percentage (80 to 90 percent) of its costs on a direct or indirect cost causative basis.

Cost Allocation Principles Conform to Accepted Industry Criteria

FCC's cost allocation principles were in general accord with an analysis prepared for AT&T by the public accounting firm of Peat, Marwick, Mitchell & Co.[8] (Peat Marwick). The analysis contained what Peat Marwick considered to be the characteristics of generally accepted cost accounting methodologies for assigning costs between business segments. While explaining that no generally accepted cost accounting standards exist in the sense that the accounting profession has generally accepted accounting principles, Peat Marwick identified some generally accepted approaches toward cost allocation on the basis of its review of accounting literature. Peat Marwick identified the following three fundamental criteria for selecting an allocation base.

- A causal relationship should exist between the cost and the activity to which it is allocated. This criterion is in agreement with FCC's emphasis on cost causation, and Peat Marwick considered it to be the preferred basis for cost allocation.

[8]Peat Marwick's analysis was attached to the AT&T reply comments in FCC Docket No. 86-111.

- The benefit of a particular cost may be identifiable and used as the allocation base when a causal relationship is not evident. That is, costs are allocated on the basis of the extent each product or service benefitted from incurring the cost. A causal relationship can generally be objectively measured whereby a purely beneficial relationship cannot.
- Fairness should be applied as a subjective criterion to test the reasonableness of the allocation base. Peat Marwick considered fairness particularly applicable to allocating costs among telecommunications lines of business because such allocations "involve balancing competing interests in an environment where there are often no absolute answers."

On the basis of these criteria, Peat Marwick presented a hierarchical approach using direct, indirect, and residual allocation measures. These are consistent with FCC's cost allocation standards. Peat Marwick stated that the accepted cost allocation hierarchy moves from the precise to the general, with the overall objective of using the most precise allocation approach that can be economically justified.

In developing its joint cost decision, FCC gave credit for elements of its plan to two sources other than the normal array of opinions and data from commenters in their proceeding. First, in a September 1983 report,[9] we endorsed the adoption of cost allocation standards put forth by the Cost Accounting Standards Board and the use of independent public accounting firms to evaluate the carriers' adherence to the standards. Second, the Telecommunications Industry Advisory Group, established by FCC to propose a revised Uniform System of Accounts, had provided a September 1984 report to FCC on cost allocation that addressed both accounting mechanisms and principles for allocating costs. The advisory group also recommended that carriers file an implementation plan and have annual independent audits of the cost allocations. The cost allocation rules FCC eventually adopted contain the major elements that we and the advisory group recommended: cost allocation standards and guidelines, written cost allocation manuals, and an oversight and enforcement mechanism that supplements FCC's own audit capability.

Implementing FCC's Joint Cost Program

To implement its newly prescribed joint cost standards, FCC has developed a number of steps in addition to its own oversight, including the submission of cost allocation manuals and annual reports by independent auditors on the carriers' cost allocation systems and allocations.

[9]GAO/RCED-83-235, Sept. 2, 1983.

Cost Allocation Manuals Subject to Public and FCC Review

Implementing FCC's cost allocation standards will be different for each carrier depending on its organization and methods of managing its operations. To help ensure compliance with the standards, FCC is requiring carriers to file cost allocation manuals for FCC approval, explaining in detail how they will apply the standards.

FCC requires that the cost allocation manuals include the following information: (1) a description of each of the company's nonregulated activities, (2) a list of activities the company treats as incidental for accounting purposes and the justification for such treatment, (3) a chart showing all of the company's corporate affiliates, (4) identification of affiliates that are or will engage in transactions with the carrier, along with a description of the nature, terms and frequency of the transactions, and (5) detailed specifications of the cost categories each USOA account and subaccount is assigned to and the basis on which each category will be allocated.

The burden of filing a cost allocation manual is limited to large carriers.[10] Smaller companies must comply with the rules although they are not required to file a manual.[11] The BOCs whose manuals are to take effect on January 1, 1988, filed proposed manuals with FCC before the September 1, 1987, deadline.[12] FCC action on the manuals is expected in the fall after rounds of public comments and replies on the manuals.

FCC's Accounting and Audits Division, consisting of accountants, lawyers, and auditors, reviews the cost allocation manuals, providing feedback to the carriers both informally and through orders approving or disapproving them. Division officials said that special attention will be given to the "auditability" of the manuals and the size of the cost "pools" that general allocators will be applied to.

As described in chapter 2, FCC has had difficulty in the past approving cost allocation plans in a timely fashion. FCC has ordered its staff to act on the manuals expeditiously, but FCC Accounting and Audits Division officials do not know exactly how long the process will take. While FCC

[10]These are the "Tier I" local exchange carriers earning over $100 million annually in regulated revenues, and AT&T, the only long distance carrier subject to FCC regulation. FCC estimates there are about 50 Tier I carriers, including 20 carriers owned by the regional BOCs.

[11]Small companies were also exempted from filing an annual attestation report (discussed in following section) and from interim reporting requirements.

[12]AT&T was required to file its manual sooner because it has already started conducting unseparated nonregulated activities.

intends that the new allocation rules will to go into effect on January 1, 1988, the officials acknowledged that all of the manuals may not be approved by that time.

Attestation Reports to Aid Commission Oversight

One very important provision in FCC's joint cost rules is for an annual report by a CPA attesting[13] that the cost system in place accurately reflects the carrier's approved cost allocation manual, and that the allocations reported to FCC were performed accurately in accordance with the system.

FCC stated, in the joint cost decision, that this requirement does not substitute for its own commitment to check carrier compliance through monitoring and auditing, but is a valuable and necessary oversight tool given its own limited resources. FCC views the attestation report as an important aid in fulfilling its responsibilities, not a delegation of such responsibilities. As with cost allocation manuals, attestation examinations will be required of only large local exchange carriers (over $100 million in regulated annual revenues) and dominant interexchange carriers. FCC stated that the requirement for an annual report is indispensable to an effective monitoring and enforcement program because FCC does not have the resources for annual on-site carrier reviews.

FCC is requiring each CPA attestation report to provide a "positive" level of assurance rather than a "negative" level of assurance. As discussed in the American Institute of Certified Public Accountants' Statement on Standards for Attestation Engagements, "positive" assurance by a CPA requires a more extensive examination than "negative" assurance, with a conclusion by the CPA stated in the from of a positive opinion. Conversely, a "negative" level of assurance requires the CPA to state only that during his review nothing came to his attention that would indicate that the data were not accurately and appropriately presented. The FCC joint cost decision calls for a "positive" opinion attesting that the carrier's costing system appropriately reflects the costing manual, and that the results accurately reflect the data produced by the cost system.

In the joint cost decision, FCC considered but did not adopt a rule under which CPAs eligible to perform attestation examinations would be designated by the Commission. FCC concluded that such designation was not

[13]The American Institute of Certified Public Accountants, in its 1986 publication, Statement on Standards for Attestation Engagements, defined an attest engagement as "one in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party."

necessary to ensure that the work was objective and reliable since CPA professional standards are sufficient to ensure their objectivity. However, FCC ruled that a carrier may not use the same CPA for preparing both the cost allocation manual and for the annual attestation report, in order to prevent bias or the appearance of a conflict of interest. As we discuss in more detail later, FCC staff will be overseeing the work of the CPAs and can take appropriate "corrective action" if a CPA has not performed objectively and competently. FCC Accounting and Audits Division officials said this corrective action could include refusing to accept a certain CPA's work if it is repeatedly bad and the CPA does not respond to FCC comments.

The Outlook for FCC's Oversight of Cross-Subsidies

Enforcement of FCC's cost allocation rules, with standards, cost manuals, auditing and reporting requirements is an unprecedented effort in FCC's limited experience with keeping costs separate through cost accounting rather than with structural separation. FCC has several means of oversight at its disposal, including (1) its tariff review process, (2) in-house audits of carrier records, (3) a new automated reporting system, (4) reviewing the work of the CPAs, and (5) relying on public comments and complaints. However, FCC plans no increase in its staff resources devoted to auditing and oversight.

Tariff Review Provides "Front End" Check

FCC tariff requirements help safeguard against cross-subsidy or carrier discrimination against a competitor, because a carrier using some of its regulated services as part of its nonregulated offerings must pay the FCC-approved tariff price, as required by the new cost allocation standards. In addition, FCC considers its tariff review responsibilities to be an important means of overseeing telephone rates and protecting the ratepayer. Review of tariffs, however, may not be as effective for overseeing FCC joint cost rules.

Before any carrier can offer an interstate regulated service to customers, it must file a tariff with the FCC. The Tariff Division in FCC's Common Carrier Bureau reviews proposed tariffs and their supporting material submitted annually by the carriers, obtains public comments on them, and then rules on their reasonableness. If a tariff's prices are not supported by the cost information, FCC may prevent the tariffs from taking effect, ask for more support, or roll back the prices. Tariff Division staff said the tariff review process helps to check whether carriers are subsidizing the cost of nonregulated services with the regulated services. In addition, regulated network services used by a carrier's nonregulated activities must be purchased at the tariffed price, thus helping to prevent unfair competitive advantages for the carrier.

Tariff Division staff said they often make adjustments in carriers' costs and rates during tariff review because carriers' estimates of usage, growth, or depreciation are not reasonable. The result is that tariff review has been a major source of savings to the ratepayer through FCC-ordered rate adjustments, according to Tariff Division staff. However, FCC's tariff review staff has only a 3-month period of time to review each carrier's proposed tariffs, obtain public comments, and make its decision before the tariffs are to be implemented. This short time period combined with the Tariff Division's limited staff,[14] requires them to give priority to the "big ticket" items and makes a detailed examination of the supporting documentation very difficult. The Accounting and Audits Division has occasionally assisted the Tariff Division with its review of tariffs when their particular expertise was needed, such as in depreciation, or with field work. The Tariff Division does not do any field work during its own tariff investigation. The Audits Branch Chief expects such assistance to continue but only on a limited basis because of staff and travel restrictions.

While the tariff review process in concept provides a safeguard against cross-subsidy, the amount of assurance it provides can be questioned at least during the next few years when nonregulated activities are still expected to be a small portion of a carrier's overall operations. Tariff Division staff said that its need to focus its limited time and resources on larger issues, such as depreciation or supporting cost data, may prevent it from doing much oversight of cross-subsidy.

Small Audit Staff Has Major Oversight Role

The key FCC staff involved in overseeing the implementation of the joint cost rules are the 15 auditors in the Audits Branch of the Common Carrier Bureau's Accounting and Audits Division. The audit staff has a major role in ensuring that carriers properly implement the joint cost rules and faces an increased workload as a result. FCC's joint cost order and our discussions with Audits Branch staff both confirm the added responsibilities, but FCC is not planning to increase staff resources in this area. (See ch. 4.)

[14]The Tariff Division has only 11 people to analyze thousands of pages of carriers' filings each year.

FCC recognizes the importance of its own audit oversight as a means of guarding against cross-subsidy, despite the increased oversight provided by approved cost allocation manuals and independent CPA attestation reports. In the joint cost order FCC stated that the "real test" of its allocation rules and the carriers' cost manuals will be the reasonableness of the allocations that result. The order continues, however, "a cost manual in complete compliance with our requirements will not produce reasonable results absent proper implementation." FCC views the CPA requirements as an aid in fulfilling its responsibilities and not as a delegation of responsibility. The CPA reports would serve as "an adjunct to an intensified Commission audit program," FCC said in the joint cost order.

Two features of FCC's joint cost rules should make the work of the Audits Branch easier. First, FCC expects its new automated reporting system to help identify problem areas for the Audits Branch concentration. Second, FCC access to the CPAs' workpapers gives its auditors a head-start when auditing a carrier. According to Audits Branch officials, these two advantages will help them work more efficiently, but the overall workload will continue to increase.

FCC has traditionally located its auditing capability in Washington, D.C., and in New York City. Staffing of the branch has increased moderately since the AT&T divestiture while its audit responsibilities have greatly increased. Before the divestiture, FCC's audit responsibilities were limited to interstate issues in AT&T's unified Bell System. Since accounting practices were then standardized across all of the Bell System companies, FCC could get good coverage of the majority of the telecommunications industry through audits at AT&T headquarters in New York or at AT&T's operating companies located near New York or Washington. With the AT&T divestiture and resulting creation of seven new regional BOCs, the potential audit areas increased many-fold. Further, much more travel is now required to reach all of the carriers.

According to the Audits Branch Chief, the FCC audit staff have performed 9 to 18 audits annually in each of the 3 years since the divestiture. He estimated that three quarters of their audit work involves cost allocation issues. For 1987, seven joint cost and two separations audits had been planned, and the Audit Branch Chief said the branch tries to do at least one audit per year at each BOC on one aspect of its operations.

In recent years, the Accounting and Audits Division has requested more staff in its annual budget proposals. For fiscal year 1985, eight auditors were added as workload greatly increased after the divestiture. The audit staff has been stable since, but for fiscal year 1988, FCC's budget submission to the Congress requested a cut of three auditors "as a result of the increased use of alternative auditing capabilities," i.e., the presence of the CPA attestation work. The impact of the proposed audit staff cut, according to the Audits Branch Chief, would limit the detail of audits, increase the extent of sampling to be done, and increase reliance on the independent CPA's work.

FCC Expects Automated Reporting Will Enhance Oversight

FCC currently is developing the Automated Reporting and Management Information System (ARMIS), a computer system on which FCC expects to rely heavily for assistance in overseeing carriers' compliance with the joint cost rules and other common carrier regulations. In conjunction with ARMIS, FCC has just instituted automated reporting requirements for the joint cost rules and will revise and automate a number of existing financial reporting requirements now done manually.[15] The ARMIS computer system and reporting requirements are still to be implemented, so it is not known how effective it will be as an oversight mechanism.

FCC adopted the automated reporting requirements for large telephone companies on July 16, 1987, to provide easy, Commission-wide access to reliable, consistent data. FCC expects the system to increase its regulatory effectiveness by aiding in its analysis of carrier revenue requirements and rates of return, providing an improved basis for audit and other oversight functions, and enhancing FCC's ability to quantify policy proposals.

The new automated reporting procedure requires that the approximately 50 Tier I carriers submit, on computer media, four new annual reports and a quarterly summary report containing financial and operating data. The Commission decided to phase in the reporting requirements over 2 years beginning in October 1987. Some specifics regarding the reporting requirements have not yet been issued by FCC.

FCC faced a dilemma in determining the reporting requirements for its joint cost rules, having to balance its need for data to protect ratepayers against the carriers' interests in protecting their proprietary data on nonregulated activities. FCC needs some data on costs allocated to nonregulated activities in order to assure itself that the costs allocated to regulated activities are just and reasonable. Thus, FCC decided to require

[15] ARMIS will include data submitted in the following areas: Uniform System of Accounts, jurisdictional separations, access charge tariffs, and joint costs.

broadly aggregated data on nonregulated activities, which does not identify specific nonregulated services.

FCC's Accounting and Audits Division expects to rely heavily on ARMIS to help oversee carriers' joint cost allocations. The staff expects to use the ARMIS data base to examine allocation ratios and percentages within a carrier and among different carriers to highlight potential problem areas needing further attention. FCC staff, therefore, expects the ARMIS analyses to target areas where FCC's limited audit resources can best be used for follow-up review.

We question how much help ARMIS will be, particularly in the next few years during the initial stage of joint cost rules implementation. Adjustments to any new system can be expected during this shake-down period. Also, it may take several years of data collection to develop enough historical trend data to allow meaningful comparisons to be made.

FCC Staff Will Oversee the CPAs

FCC will extend its own audit coverage by requiring annual CPA reports attesting that the carriers comply with the joint cost rules. To help ensure the quality of these reports, FCC will oversee the work of the CPAs by reviewing the annual CPA attestation report submitted to FCC or reviewing the CPA's workpapers supporting the report. While the ability to review CPA workpapers will enhance FCC's oversight capability, it is not known how much help the reports themselves will be since their content has not been clearly defined.

The joint cost decision contained only a short narrative explaining the content of the annual CPA report, so it is not yet clear exactly how informative it will be. Accounting and Audits Division staff admitted that the content of the CPA's report submitted for FCC review has not been specified. Representatives of CPA firms interviewed agreed that the joint cost rules were not specific and they were not sure what attestation reports would include. FCC guidance on the content of the attestation report is clear, however, in stating that the CPAs will not be required to submit any proprietary data of the carrier.

FCC has time to issue additional guidance, since the first CPA reports will not be submitted to FCC until 1989 at the earliest, covering 1988 carrier activities. The timing of the attestation report will depend on when a carrier begins implementing its approved cost allocation manuals.

FCC's joint cost rules do provide for FCC access to the CPA's workpapers and other documentation of the attestation examination, which is expected to enhance its own staff audits and oversight. However, the workpapers and other material will not be routinely filed with FCC because of concerns over protecting proprietary data. FCC has required that the carriers provide for FCC access in contracts with the CPAS for the attestation work.

Role of Public Comment and Complaints Limited

FCC has traditionally relied on comments and complaints from interested parties to help it oversee its regulated carriers. In particular, FCC officials have stated that, while striving to carry out FCC responsibilities in recent years with fewer resources, they rely upon the complaint process to monitor specific abuses. FCC staff have also indicated that the complaints process will have a role in overseeing the cost allocation process. We believe this role will be limited, however, because the small amount of data that FCC will routinely make public on the carriers' nonregulated activities limits the bases on which the public can file complaints with FCC.

While the carriers' cost allocation manuals will be subject to public comments before FCC approves them, the public will have limited access to information on the carriers' cost allocations. The details of the attestation audits will not be made public or routinely filed with FCC. Also, the carrier data reported to the ARMIS system pertaining to carriers' nonregulated activities will be very broadly aggregated. FCC has a legal mandate to protect carriers' proprietary data from public disclosure.[16] However, the limited amount of publicly available data concerning carriers' cost allocations will also make it difficult for complainants to make a factual case accusing a carrier of cross-subsidy.

The Implementation Schedule Is Full

The adoption of joint cost rules is part of the overall movement of FCC's regulatory program towards nonstructural safeguards, which is a detailed and involved process that FCC plans to implement in a relatively short period of time. The new regulatory scheme depends on a number of interrelated elements that must fit together smoothly, on time, and in sequence in order to work well. Some reporting requirements have yet to be determined by FCC. Also, FCC is involved with several other regulatory

[16] Section 220(f) of the Communications Act of 1934

changes to be effective in 1988, which affect FCC's joint cost rules' implementation schedule. Some schedule slippage has already occurred. The following is a partial schedule of events.

- October 1987
  - proposed 1988 carrier access tariffs due and
  - first stages of ARMIS computer system to become operational.
- January 1, 1988
  - carriers can implement cost manual, if approved;
  - revised USOA takes effect; and
  - revised jurisdictional separations process takes effect.
- February 1, 1988
  - carrier ONA plans due and
  - FCC to propose reporting requirements for cost allocation forecast data.
- June 1, 1988
  - carrier 1988 cost allocation forecast data due.

Cost Allocation Manuals

FCC's joint cost decision set September 1, 1987, as the deadline for carriers to file cost allocation manuals based on the revised USOA.[17] A September filing date was set because FCC wanted the carriers to use their cost manuals in developing the support for their proposed 1988 access tariffs[18], due to FCC in October 1987.

ARMIS System

FCC's ARMIS system, currently under development, is designed to be the vehicle through which the revised USOA and jurisdictional separations systems, as well as the joint cost program will all be reported. FCC's schedule calls for the ARMIS system to become operational in stages between October 1987 and June 1988 as various reporting requirements

[17] Carriers that wished to eliminate structural separation as soon as possible could file cost manuals based on the old USOA earlier, but still had to file a manual based on the revised USOA by September 1.

[18] The access tariffs list the local telephone companies' charges and conditions for connection to the local exchange for the origination and termination of long distance services.

take effect. FCC is in the process of procuring equipment and developing software for the ARMIS computer system. The first ARMIS analysis is scheduled to be the 1988 access tariff data between October and December.

Reporting Requirements

FCC's July 1987 decision on automated reporting requirements set a tight schedule for implementing portions of the new reporting rules. The implementation timetable delays until later determinations on requirements and formats for some of the new reports.

For example, FCC decided not to implement a quarterly reporting requirement until after the new USOA becomes effective in 1988. The complete details of the technical computer specifications are to be issued October 31, 1987. The first report on the quarter ending on March 31, 1988, is due June 30, 1988. Carriers also will be required to submit annual forecasts of their expected cost allocations, but FCC will not propose what data it needs for 1988 until February 1, 1988. FCC currently has scheduled June 1 as the filing date for 1988 data, which is 5 months after the forecast subject year begins. Thereafter, forecasts will be required by December 1 before the subject year begins.

Implementation of some other annual reports is also delayed until after the new USOA is effective. The FCC staff is to issue details of the report for detailed USOA, separations, and access results by July 1, 1988, and the first data on this report will not be filed until April 1, 1989.

CEI and ONA Safeguards

Computer III described the regulatory concepts of CEI and ONA which are nonstructural safeguards that are to be available from carriers to allow competitors' use of the regulated telephone network for competitive services on an equal footing with the carriers themselves. FCC set no deadlines for CEI because carriers have the incentive to offer CEI in order to remove the structural separation requirements. FCC will approve or deny all CEI plans only after soliciting public comment on them. According to FCC the ONA concept builds upon CEI goals of preventing discrimination and promoting efficiency, but generally without the need for service-specific CEI plans. The Computer III decision set a deadline of on or before February 1, 1988, for carriers to file their ONA plans.

What the Joint Cost Rules Do Not Cover

The limited scope of the joint cost rules has raised concerns by some telecommunications interests about potential negative effects of non-structural regulation beyond cross-subsidy. These include such areas as unfair pricing of nonregulated products, impact on the costs of capital in the event of losses in the nonregulated area, improper transfer of liabilities such as unused equipment from the nonregulated to the regulated businesses, or allocation of costs for intangible benefits or costs, e.g., a company's reputation.

In the joint cost order, FCC stated that such issues would be better addressed in separate proceedings, in tariff reviews, in facilities regulation, or in decisions on carriers' proper rates of return. In the order, FCC considered, but declined to address (1) the issues of anticompetitively low nonregulated prices, because such a complaint is addressed by antitrust law and (2) the allocation of intangible benefits and the increased cost of capital, because they were outside the scope of the joint cost proceeding.

Another area into which the cost allocation rules and Computer III do not enter is regulation of the investments carriers make in unregulated activities. Under Computer II carriers had to file "capitalization plans" with FCC detailing the transfers of assets from carriers' regulated operations to their unregulated separate subsidiaries. The aim was to control the potential for harmful subsidies and to determine that the subsidiary would establish financial independence at some definite time and assume the risks for its competitive venture.

FCC stated in the Computer III decision that these concerns are more effectively addressed by less burdensome regulatory measures. FCC stated that "it appears that entry into unregulated areas will not lead to massive hemorrhaging of capital from regulated operations." Instead FCC found that improper allocation of costs was a more important concern. FCC concluded that the prevention of degradation of basic services and controlling increases in the costs of capital for regulated activities due to significant nonregulated investments could be addressed by conventional tariff and facilities regulation at the state and federal levels.

FCC's Cost Allocation Rules Will Provide Only Limited Assurance That Cross-Subsidy Is Being Controlled

FCC is in the midst of implementing its new cost allocation rules and procedures—using accounting controls instead of separate subsidiaries—thus, it is impossible to forecast exactly how well these new controls will work. As discussed earlier, there is great concern about the growing potential for carriers to subsidize their competitive activities in the future. Based on our assessment of FCC's progress and plans to date, however, we believe FCC will not be able to provide positive assurance that carrier costs are being properly allocated and cross-subsidy is being controlled. Since FCC's new regulatory program requires more oversight than the structural separation approach, it is essential for public acceptance of the program that FCC be able to provide a high degree of assurance to ratepayers and carrier competitors that cross-subsidies are being properly controlled.

FCC has stated in its joint cost decision that it is critical to oversee how the carriers implement the rules and procedures. We concur that oversight is important, especially in the first few years when it is essential that the carriers implement the new procedures properly, with the benefit of timely feedback from FCC. In addition, because FCC in recent years has actively promoted deregulation in the telecommunications industry, it is essential for FCC to provide assurances to the public that it is serious about fulfilling its regulatory oversight responsibilities. Whether a continued program of intense oversight is necessary in later years may depend on proper guidance and direction initially.

The CPA attestation reports will go a long way toward assuring FCC the new procedures are properly implemented, in particular concerning such aspects as adequacy of carrier documentation and consistency of application from year to year. However, the unavoidably subjective elements contained in (1) the cost allocation process, (2) the CPA attestation, and (3) FCC's mandate to determine that rates are "just and reasonable," require ultimately that FCC exercise its own judgment that the carriers' costs are properly allocated.

FCC's access to carriers' books and records is its main oversight mechanism in making these judgments. Its other means of oversight—tariff review, the ARMIS system, the complaints process, and review of CPA attestation reports—are also important, but these are essentially indicators of potential problems that may lead FCC to audit carriers and ultimately decide if costs are properly allocated.

The basis on which FCC will routinely determine that cost allocations are properly preventing cross-subsidies is questionable. The absence of complaints or other indicators of problems may cause FCC to conclude that no problems exist, but as we discussed in chapter 3, these indicators may not be effective, at least initially. While FCC will certainly investigate major problems if they are brought to its attention, it is also important for FCC to routinely sample carrier books and records to assess compliance and also judge the CPAs' work. We see FCC at present with only the ability to do infrequent reviews of carrier records, given available audit staff and travel funds. Further, FCC's fiscal year 1988 budget request proposed to eliminate three auditor positions.

Judgment Is an Inherent Element of FCC's Cost Allocation Rules

Part of FCC's past problem with cost allocations, as we discussed in chapter 2, has been the inherent subjectivity of the cost allocation process. FCC's new joint cost rules are an attempt to deal with the problem by specifying procedures and requiring carriers to have cost manuals. Together, these serve as objective means against which FCC and the CPAS can judge compliance. Still, subjective elements will continue to play a major role in the entire process, given the difficulty in objectively allocating the costs of telephone services sharing common equipment, coupled with the judgmental aspects of both the CPA attestation audit and FCC's obligation to see that rates are "just and reasonable."

The public accounting firm, Coopers & Lybrand, in commenting on FCC's joint cost rules, recognized the value of the independent attestation, but concluded that FCC still has the major responsibility for evaluating the entire process. Coopers & Lybrand stated that

> "The use of independent audits will provide the federal regulator with verification that the numerical calculations are accurate and data sources are reasonable, and both reflect the approved cost manual procedures. This type of audit is quite far-reaching and informative as to compliance with cost allocation procedures employed by an individual carrier. However, in such audits, the adequacy of the cost allocation plan is assumed. The independent audit process is not intended to serve as a means to draw parallels or to make qualitative or quantitative judgments on another company's cost allocation manual process. As the [joint cost] Order states, the FCC retains the major burden on determining initial compliance and on the evaluation and monitoring of the process as a whole."[1]

[1] Assessment of Current Status of FCC Cost Accounting Initiatives: CC Docket 86-111, prepared by Coopers & Lybrand for United States Telecommunications Suppliers Assn., Mar. 1987, p. 17.

Written comments provided by two other public accounting firms in FCC's joint cost proceeding both recognized the subjective elements involved in making cost allocations. One firm, Price Waterhouse, helped prepare a draft cost allocation manual for Southwestern Bell Telephone Company that was over 100 pages long and contained specific detailed instructions on how to allocate each of Southwestern Bell's various expenses. Despite the detail, however, the manual recognized the subjective nature of cost allocations. For example, the manual states that ". . . no generally acceptable allocation technique has been identified as appropriate in all circumstances." The manual also discussed allocating general overhead expenses (such as officer salaries) on an "intuitively logical manner."[2] Similarly, comments prepared by the accounting firm, Peat, Marwick, Mitchell & Co., setting forth its view on cost accounting methodologies, stated that "There will always be tradeoffs in the selection of an approach, namely precision, reliability, and level of information against the cost of implementation."[3] In this regard, a paper prepared by an economics consulting firm discussing FCC's proposed joint cost rules stated that allocation problems are

". . . caused not by accounting abuses but by the arbitrariness of allocations used to divide joint costs, the discretion that must be given to the firm to decide which of several allocators to use, and the ability of the regulated firm to choose resources and technologies that evade the constraints of the costing process."[4]

The attest examination itself will also require the exercise of judgment on the part of the CPA. The American Institute of Certified Public Accountants' Statement on Standards for Attestation Engagements is to be followed by CPAs doing attest work. This statement recognizes the role that judgment can play in reaching a conclusion. It says,

"Competent persons using the same or similar measurement and disclosure criteria ordinarily should be able to obtain materially similar estimates or measurements. However, competent persons will not always reach the same conclusion because (a)

[2]Cost allocation manual prepared by Price Waterhouse, submitted with comments of Southwestern Bell Corp. on Docket 86-111, June 1986, section 2, p. 10.

[3]"Evaluation of Cost Allocation Manuals," prepared by Peat, Marwick, Mitchell & Co., submitted with reply comments of American Telephone and Telegraph Co., on Docket 86-111, July 1986, p. I-8.

[4]Accounting Separations: A Contradiction in Terms, by Cornell, Pelcovits & Brenner Economists Inc., Mar. 1986, p. 23.

such estimates and measurements often require the exercise of considerable professional judgment and (b) a slightly different evaluation of the facts could yield a significant difference in the presentation of a particular assertion."[5]

The statement also says the CPA should consider "materiality" when reporting his conclusion. A CPA's judgment of what is material may well differ from that of an FCC regulatory auditor.

The ultimate exercise of judgment occurs when FCC carries out its "public interest" responsibility and determines that rates are "just and reasonable." This concept appears to be similar to the concept of "fairness" that was mentioned in chapter 3 as being a fundamental criterion in any allocation process. FCC defined "just and reasonable" in the joint cost order as both (1) protecting ratepayers by assuring rates do not subsidize nonregulated services and (2) promoting savings to the ratepayer from the integration of regulated and nonregulated services.

For example, based on its "public interest" responsibilities FCC could require a carrier to adjust its cost allocations if, in its judgment, the result would be more nonregulated services being offered. In justifying its Computer III decision, FCC cited such a service, called Custom Calling II, that no carrier had offered while structural separation requirements were in effect.

Assurance Is the Key to Acceptance of FCC's New Regulatory Program

It is essential that FCC create public confidence in its new regulatory program to ensure both telephone ratepayers and firms competing with carriers that a carrier's regulated services do not subsidize its nonregulated activities. Assurance is particularly important over the next few years to counter the uncertainty and anxiety that will exist over (1) how both the carriers and competitors will behave under a new set of regulatory ground rules and (2) how effectively FCC will oversee the program. As time goes by, the need for assurance may lessen as everyone's comfort level with the program increases.

The Department of Justice consultant's report, The Geodesic Network, discussed both the potential and likelihood of cross-subsidy occurring if carriers entered a number of nonregulated telecommunications markets. The report generally found moderate to high percentages of costs potentially shiftable from nonregulated to regulated operations. However, the

[5]Statement on Standards for Attestation Engagements, American Institute of Certified Public Accountants, Mar. 1986, p. 10.

report generally did not see any cross-subsidy having much of an immediate impact on regulated rates because of the small size of the nonregulated activities compared with regulated operations.

Cross-subsidy is not a large problem at present but the potential is great. Where a firm operates in two markets—one it monopolizes and another with many competitors—it has an incentive to subsidize the competitive markets by undercharging for competitive services and/or shifting costs to the captive monopoly market. Cross-subsidy has not been a large problem to this point because carriers' relatively small investments in competitive markets dilute any impact on telephone rates. The potential will become greater in the future for a number of reasons. First, carriers are increasingly investing in competitive ventures. Second, the recent decision by the divestiture court relaxed some restrictions on BOCs' investment in competitive areas. Although the BOCs did not get all the relief they wanted, the court opened new areas e.g., the ability to provide information service transmission. Third, FCC's Computer III regulatory scheme allows monopoly and competitive operations on an integrated basis making cross-subsidy more difficult to detect.

The Justice consultant's report presented a hypothetical example of the potential cross-subsidy due to cost shifting by a carrier offering nonregulated electronic mail service.[6] Two-thirds of the costs of an electronic mail operation could be potentially shiftable to similar cost categories in regulated operations, the report said. The example showed that $200 million, or 11 percent, of a carrier's regulated costs fall into categories potentially shared with an electronic mail operation. If there was a 10-percent increase in these $200 million of regulated costs due to cross-subsidy, there would be only a 1-percent increase in total carrier regulated costs, a small impact on regulated rates. However, this same 10-percent increase on the regulated side due to cost shifting would yield a corresponding decrease of 7 percent in nonregulated costs, a significant impact on competitive operations.[7]

FCC's requirement that each CPA attestation report provide a "positive" level of assurance rather than a "negative" level of assurance will provide FCC a greater degree of assurance. However, FCC's own oversight of

[6]Electronic mail service is defined as a computer-based method of transmitting information that involves composing messages on a computer terminal, transmitting them electronically, and storing them in computer storage for later retrieval by a recipient.

[7]The Geodesic Network, 1987 Report on Competition in the Telephone Industry, Consultant's Report to the U.S. Department of Justice, Jan. 1987, pp. 11.16-11.18.

the cost allocation program will provide only a "negative" assurance that cross-subsidy is not occurring because of the limited FCC staff available to examine carrier books and records.

Limited FCC Staffing Will Reduce the Level of Assurance

Adequate FCC resources for overseeing and enforcing cost allocation rules has been a concern both in past FCC actions related to Computer II and also in connection with Computer III and the joint cost rules. In the Computer II decision and related proceedings, FCC indicated that among the reasons structural separation was preferable to accounting controls alone was that such controls were more difficult to implement, and could require added staff and more intrusion in monitoring efforts. Similar concerns over FCC's oversight capability were raised in June 1986 by several commenters in the joint cost proceeding. In particular, the Department of Justice recognized the benefits of requiring annual CPA audits but still called for a "vigorous" FCC audit program focusing on both problem areas and randomly selected companies. Justice comments expressed concern

> ". . .that at present the Commission does not have a sufficient number of auditors to take on the increased responsibilities resulting from this proceeding. The failure to devote sufficient resources to the audit process will reduce any prophylactic program, no matter how sound in theory or principle, to a sham that deceives rather than protects ratepayers and state regulators. Thus, we cannot stress too strongly the importance of the commission allocating adequate resources to enforce the accounting rules before separate subsidiary requirements are eliminated."[8]

The North American Telecommunications Association said that if FCC is to fulfill its auditing objectives, it must immediately seek staff reassignment within FCC and pursue additional funding for the auditing functions.[9] In rebuttal, FCC said that it was committed to fulfilling this oversight responsibility, but did not provide any specifics on its plans to audit carriers. FCC's Common Carrier Bureau staff informed us that they are optimistic about preventing cross-subsidy and cited the elements of its program to oversee the cost allocations, i.e., CPA attestation reports, the ARMIS system, and FCC audits.

[8]Comments of the U.S. Department of Justice on Docket 86-111, June 1986, p. 36.

[9]Comments of the North American Telecommunications Assn., on Docket 86-111, June 1986, pp. 38 and 39.

Requests for Increased Audit Staff Denied

Since fiscal year 1983, overall staffing of the Accounting and Audits Division has more than doubled, with Audits Branch staff increasing by eight auditors in the post-divestiture year of 1985. For fiscal year 1987, the Division has approximately 67 persons, including 22 in the Audits Branch. Of the 22 staff members, the branch has 15 persons listed as auditors, while the remainder are in management, legal, and support categories. FCC has requested additional auditors in its recent budget proposals to the Office of Management and Budget (OMB), but increases have not been approved. In fact, FCC's fiscal year 1988 congressional budget submission called for a decrease of three auditors.

For fiscal years 1987 and 1988, FCC's proposals to OMB were for an added nine and three auditors, respectively. However, the FCC congressional budget submissions asked for no additional auditors in 1987 and the reduction of three positions in 1988. The justifications for the increases were similar: The Commission is increasingly relying on auditing to protect ratepayers from bearing costs that are not associated with regulated services and to ensure fairness in the marketplace. Other factors contributing to an increase in audit requirements included an increase in the number of regulated carriers as a result of the AT&T divestiture, the increased movement of such regulated companies into unregulated businesses, revisions of the manual used in separating costs between interstate and intrastate services, the monitoring of Computer II and III compliance, the implementation of the revised Uniform System of Accounts, and, of course, the implementation of the carriers' cost allocation manuals under the joint cost decision's standards.

To justify its proposal for the additional auditors for 1988, FCC's Common Carrier Bureau said that it had identified 256 areas[10] in the operations of the major carriers that it had responsibility for auditing on a routine basis. The Bureau acknowledged, however, that resources were unavailable to perform these audits annually. Instead, according to the Bureau, a more reasonable plan would be to spread out the audits in order to control costs while still giving the Commission some assurance that carriers are complying with rules. Its proposal was to conduct about 32 audits a year, meaning FCC would audit each of the 256 areas once every 8 years. FCC also calculated that on the average this level of effort would allow it an audit presence at most of the major carriers once every other year.

[10] FCC identified the 256 areas requiring audit attention in the 20 operating companies owned by the regional BOCs, the 7 regional BOCs themselves, and 2 other major independent telephone companies—GTE and United Telecom. The regulatory areas included were USOA, separations process, access charges, joint costs, Computer III, and depreciation rates

Because FCC's requests for more auditors in each of its past two budget proposals have not survived OMB review, they have not been included in the congressional budget submissions. Reasons cited were to cut budgets and alternatives to in-house auditing, i.e., the independent CPA reports.

While FCC had requested increased staff to allow it to conduct 32 audits a year, we noted in chapter 3 that in recent years it had conducted between 9 and 18 audits annually. If an annual level of 16 audits per year with present staff is assumed, FCC would examine each of its audit areas at the major carriers or holding companies only once every 16 years. With the further staffing reduction requested for fiscal 1988, the interval between audits increases even further. While FCC has the discretion to prioritize its audit areas and thus to audit the joint cost allocations more frequently than every 16 years, to do so would short-change its other audit responsibilities, such as the USOA financial reports, separations process, depreciation rates, and access charges.

It is conceivable that FCC auditors, being able to rely on the work conducted by CPAS, may be able to conduct their own audits more quickly and thus increase their productivity even with fewer auditors. However, this is not likely at current budget levels, since FCC staff said that a major constraint on their audit capability is travel funds with which to visit the carriers' offices. Bureau officials reported that only $34,000 had been allotted for audit travel in fiscal 1986 and $32,000 will have been spent on audit staff travel in fiscal 1987. FCC had unsuccessfully proposed a $184,000 increase to OMB for 1987 for the existing and proposed staff. FCC's fiscal 1988 congressional budget submission, which is still pending, would result in an increase of $35,000 for Common Carrier Bureau travel. If approved, FCC officials said that the Audits Branch will receive some of this increase.

Statements by FCC officials regarding staffing have been inconsistent. In February 1987, then FCC Chairman Fowler defended the proposed FCC cut of three auditors before the Senate Appropriations Committee. He said that

> "As the regulated telephone companies provide us with independent detailed audits of their operations, we believe we can eliminate one of the audit teams we presently have without adversely affecting our regulatory responsibilities."[11]

[11] Testimony of Mark S. Fowler before the Subcommittee on Commerce, Justice, State, the Judiciary, and Related Agencies, Senate Committee on Appropriations, Feb. 1987.

Previously, at the December 1986 meeting when the Commission adopted the joint cost rules, Commissioner Mimi Dawson told her fellow commissioners that this effort is "an area where we desperately need resources. Without this, the strides we've made won't be able to move forward."

Conclusions

The actions FCC has taken in prescribing cost allocation standards, requiring FCC-approved cost manuals, and requiring annual CPA attestation reports are essential steps in implementing a program of accounting controls to guard against cross-subsidy. FCC expects these measures to help overcome problems encountered in its past cost allocation activities, which we discussed in chapter 2. Together, FCC expects these measures to go far towards providing assurance that its rules and procedures are being followed consistently and that the carriers' cost allocations are adequately documented and accurately prepared. However, FCC still has a major role to play in overseeing the allocation process and ultimately accepting the carriers' results, given the subjective nature of the process and FCC's "public interest" mandate.

FCC is embarking on a new regulatory program designed to be less restrictive on carriers' activities but that paradoxically may require a greater degree of FCC oversight. FCC has said that it is committed to fulfilling its oversight responsibility, but also has proposed in its congressional budget submission to reduce its audit staff. We share Justice's concern over the need for adequate resources to ensure the integrity of the entire program.

FCC plans to audit carrier records periodically, but at existing staffing and auditing levels these audits will be infrequent, conceivably once every 16 years. At this staffing level, FCC's substantive role may be limited to responding to complaints or problems brought to its attention, but as we noted in chapter 3, the complaints process FCC has relied on to oversee carriers in the past may not work well due to restrictions on public availability of data on carriers' nonregulated activities.

Overall, the level of oversight we see FCC prepared to provide will not, in our opinion, ultimately provide telephone ratepayers or carrier competitors positive assurance that FCC's joint cost rules will guard against cross-subsidy. Such assurance is important in the future with the growth in carriers' competitive ventures, the loosening of restrictions on their entry into more of these ventures, and the increased potential for undetected cross-subsidy in the absence of structural separation requirements.

FCC needs to match its stated intent with plans and resource commitments to assure that it can perform its oversight role in a timely and thorough fashion. It would be a small consolation for a business that tried unsuccessfully to compete with a regulated carrier to learn from FCC years later that costs had been misallocated, thus hurting its ability to compete. The telephone ratepayers need more immediate assurance as well that allocations are being done fairly.

We cannot say exactly how often FCC should audit or whether the absence of audits will result in undetected cross-subsidy. Certainly the absence of audits increases the risk that cross-subsidy will occur. As we noted in chapter 3, past FCC audits have not resulted in findings of major cost misallocations, so additional resources cannot automatically be expected to result in savings to the ratepayer. However, as we have pointed out, the potential for cross-subsidy is great given the competitive and regulatory environment. An aggressive program of carrier audits by FCC, building on the annual CPA attestation reports, will help create public confidence in the program and send a message to carriers that they can expect FCC to be closely monitoring their activities, at least initially, to make sure they get started properly.

Recommendation to the Chairman, Federal Communications Commission

We recommend that FCC develop a strategy for providing greater levels of oversight and assurance that carriers are properly implementing its cost allocation procedures. The key to the immediate success of such a strategy or plan is FCC's commitment to allocate sufficient audit staff and travel funds, obtained either by reallocation of current FCC resources or through additional funding.

Elements of a successful strategy should include plans for periodically examining both carrier records and the workpapers supporting the CPA attestation reports. In addition, a strategy should incorporate the flexibility to investigate problem areas identified through the ARMIS system, tariff review, and other means, as well as auditing carriers selected at random. FCC will have to set priorities, since it will likely face continued resource constraints. However, with the ARMIS system and greater audit coverage provided by the CPAS, FCC may ultimately be able to develop alternative review and audit techniques less resource-intensive than its traditional full-scale audits. Also, less frequent audits may be needed once the carriers have become used to the cost allocation procedures and FCC has completed an audit cycle.

Request Letter From the Chairman, Subcommittee on Telecomunications, Consumer Protection and Finance, House Committee on Energy and Commerce

NINETY-NINTH CONGRESS

U.S. House of Representatives

SUBCOMMITTEE ON TELECOMMUNICATIONS,
CONSUMER PROTECTION AND FINANCE
OF THE
COMMITTEE ON ENERGY AND COMMERCE
WASHINGTON, DC 20515

ROOM B-331
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-9304

April 22, 1986

The Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
Room 7000
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

As you may know, the Subcommittee on Telecommunications, Consumer Protection and Finance is currently engaged in a review of the restrictions in the Modified Final Judgement (MFJ) that prohibit the Bell Operating Companies from engaging in certain lines of business. While there is increasing support to modify these restrictions, there is also substantial concern that the restrictions be modified in conjunction with the establishment of specific safeguards to protect telephone ratepayers and competition.

One of the most important issues under review today is the use of structural separations and/or accounting and cost allocation rules to minimize cross-subsidization between regulated and nonregulated activities. As you are well aware, this issue has significant implications for ratepayers and the development of competition in the communications industry.

The current debate has raised several important and difficult questions concerning the apparent inefficiencies associated with structural separations, and the most appropriate and effective types of accounting and cost allocation methodologies. In addition, concerns have been raised concerning the allocation of joint and common costs between regulated and nonregulated activities, as well as the ability of regulatory authorities to devise, monitor, and enforce accounting and cost allocation rules effectively.

Given the complexity of these issues and GAO's experience in this area, I would like to request that your office assist the Subcommittee in reviewing these important matters. More specifically, I request that the GAO evaluate the current regulatory environment and provide the Subcommittee with information and data concerning the advantages and disadvantages of the use of 1) structural separations, and 2) accounting controls and cost allocation rules necessary to prevent or minimize cross-subsidization between regulated and nonregulated activities.

Due to the urgency and importance of this matter, I would like for your office to begin work on this request as soon as possible. Please contact Michael Perko of the Subcommittee staff to discuss and coordinate the requested work.

Finally, I would like to take this opportunity to commend the work that GAO's Federal Communications Commission group has done for the Subcommittee in the past. Their work and analysis have been very helpful in this highly technical and complex area.

I look forward to working with you on this and related matters in the future.

With best wishes,

Sincerely yours,

Tim Wirth

Timothy E. Wirth
Chairman

Request Letter From Representative Mike Synar, House of Representatives

MIKE SYNAR
2D DISTRICT OKLAHOMA

COMMITTEES
ENERGY AND COMMERCE
JUDICIARY
GOVERNMENT OPERATIONS
SELECT COMMITTEE ON AGING

Congress of the United States
House of Representatives
Washington, DC 20515

WASHINGTON OFFICE
2441 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON DC 20515
(202) 225-2701

DISTRICT OFFICE
2822 FEDERAL BUILDING
125 SOUTH MAIN STREET
MUSKOGEE OK 74401
(918) 687-2533

October 7, 1986

Honorable Charles Bowsher
Comptroller General of the United States
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

Legislation has been introduced in both the House of Representatives and the Senate which would alter the 1982 Modification of Final Judgement (MFJ) which separated AT&T from its local operating companies and settled the Justice Department's antitrust case filed against the Bell System in 1974. In light of the massive confusion and unusually large increases in local telephone rates which consumers experienced following divestiture, I am deeply concerned about the impact of this legislation on the average residential telephone consumer.

One of the most fundamental questions concerns the ability of regulators to ensure that residential ratepayers, who have no alternative to the local telephone company for regular telephone service, are not charged the costs of new competitive ventures if the current restrictions are modified or lifted. The Federal Communications Commission, Congress, economists, and other independent experts have long agreed that a monopoly which has bottleneck control of its market has both the incentive and the ability to discriminate against potential competitors, and to have its captive ratepayers pay the cost of its competitive efforts. Such cross-subsidies result in higher rates for consumers than otherwise would be necessary.

Various mechanisms have been considered to protect consumers from this problem: separate subsidiaries, "arms length" affiliate relationships, equal access, accounting procedures, enforcement capabilities, and the use of state public utility commissions in addition to the FCC.

GAO has been deeply involved in studying these and related issues over the years, having completed a number of reports in this area. I am aware that GAO is currently examining some of the issues involved in this important debate.

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However, a more thorough and comprehensive GAO study is essential in order for Congress to make informed decisions which will safeguard the interests of residential telephone customers. I would like to request that GAO continue its ongoing work, and expand their efforts to include several other important areas.

Three broad areas of questions arise as a result of the current MFJ modification proposals pending before the House and Senate. First, have federal and state regulators demonstrated the desire or motivation to police BOC behavior at the level necessary to protect captive ratepayers? Second, do federal and state regulators have the necessary authority to enforce the specific rules and guidelines established by themselves and Congress? Third, do federal and state regulators have the resources necessary -- in terms of staff and expertise -- to police adequately BOC behavior and enforce their decisions?

There may be good public policy reasons to modify the MFJ as it currently stands. But any modifications to the MFJ or a transfer of jurisdiction of the MFJ away from the court involves an enormous expansion of regulatory responsibilities for both the FCC and state utility commissions. Today, these agencies face very complicated regulatory issues just within the regulated services currently offered.

Moreover, it is a considerable task for regulators to oversee the creation and operation of the current multi-billion dollar BOC diversification efforts. This includes capitalization plans for BOC competitive subsidiaries and other numerous business and financial interactions between BOC affiliates. The regulatory difficulties these new functions entail are illustrated by the initial auditing reports by the California Public Utilities Commission and the National Association of Regulatory Utility Commissioners (NARUC), efforts by the FCC to deregulate partially AT&T's long distance rates, and the problems arising from the implementation of new FCC accounting rules for AT&T to replace the current separate subsidiary rules adopted in the Commission's Second Computer Inquiry.

Most of the business activities discussed above are not directly linked to local telephone service, so oversight and auditing are easier than in the lines of business tied directly to local telephone service. However, even in those areas the recent California PUC audit has highlighted the consumer protection problems arising in the current diversification activities of the BOCs.

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The BOCs now are proposing that they be allowed to offer competitive services which are interrelated directly -- physically and transactionally -- with local telephone service; i.e., long distance, information services, and equipment manufacturing. Moreover, many BOCs apparently want no corporate division or division between the monopoly and competitive businesses. While a separate subsidiary does not eliminate the incentive to cross-subsidize, it does highlight the transactions between the two entities, easing the job of auditing these transactions.

I have enclosed an outline of a study which would help to clarify many of the questions raised by proposals under consideration by Congress to modify the MFJ. I would like for this study be completed as soon as possible, and also request periodic briefings by GAO investigators on the progress of this report.

Thank you for the important work GAO has already done on this issue, and for your continued assistance in this matter. Please do not hesitate to contact John Hollar of my staff to discuss this request further.

With best wishes,

Sincerely,

Mike Synar

I. Effectiveness of Behavioral Regulation

A. General

1. Describe FCC's efforts in regulating and controlling the actions of AT&T and the BOC's to protect consumers and competitors from cross-subsidy -- both before and after divestiture.

2. To what degree did FCC inability (if any) to control BOC and AT&T behavior lead to the Government's anti-trust case against the Bell System?

3. What are the pros and cons of FCC's proposed use of accounting controls versus the current system of relatively strict prohibition on the mixing of monopoly and competitive services mandated by the consent decree?

4. What channels are currently in place at the FCC for investigation, resolution, and appeal of complaints regarding cross-subsidy by BOCs?

B. New Accounting Procedures

1. How long has the FCC been working to develop a uniform system of accounts for the telephone industry? What is the current status of this effort?

2. How long has the FCC been working to develop a new cost allocation system designed to separate "monopoly" from competitive costs?

3. What has been the Congressional role in these proceedings? Has the FCC been responsive to Congressional direction?

4. What is GAO's judgment of the usefulness of the proposals the FCC has recently made for a new system of accounting controls in protecting ratepayers from cross-subsidies?

5. In the GAO's estimation, can these proposed accounting safeguards prevent the cross-subsidies recently found in studies by the California PUC and NARUC from re-occurring?

6. What is the timetable for the implementation for this plan?

7. How many FCC staff will be assigned to administer and enforce accounting rules?

8. How often and in what level of detail would such staffing allow audits of individual BOC's and RBOC's?

9. What is the FCC's position on mechanisms which have been discussed as alternatives or supplements to accounting procedures, such as separate subsidiaries, independent auditing, "arms length" transactional standards and others?

C. Joint and Common Cost Allocation

1. To what extent does the FCC expect BOC information services to involve sharing of equipment, maintenance costs, operating expenses, staff, information, and or capital?

2. How does the FCC propose to allocate shared costs to ensure monopoly ratepayers pay for only the costs associated with the provision of local telephone service?

3. In the past, has the FCC been successful overseeing telephone companies' allocation of these costs between different services? Which method is best used by the FCC to protect ratepayers in determining cost allocation: fully distributed, marginal, or causation?

4. What is the GAO's evaluation of the current FCC cost allocation guidelines and enforcement?

D. Failed Diversification Efforts

1. What safeguards is FCC proposing to protect ratepayers when an RBOC investment is made in a new diversified line of business closely related to regulated local telephone service and the new venture fails?

2. What safeguards is FCC proposing to protect ratepayers when an RBOC investment is made in a new diversified line of business closely related to regulated local telephone service and the new venture fails?

3. Under FCC's cost allocation proposal, how could the costs of any failed investment closely interrelated with the provision of local telephone service be written off if the need arose? Would that affect the cost of capital of local telephone service?

E. Information Needed by Regulators

1. Historically, have the FCC and state regulators experienced difficulties in obtaining needed information from the former Bell System and more recently from the RBOC's?

2. What were the recent findings of the California PUC and the NARUC auditors with respect to RBOC provision of information critical to monitor ratepayer issues affected by the current diversification efforts?

II. Resources of Regulators

1. Due to Gramm-Rudman mandatory budget cuts, the FCC's budget recently was cut $4.8 million. What impact does FCC expect these cuts to have on the agency's analytic and enforcement capabilities in the cost allocation area?

2. What is the prognosis for future FCC budgets?

3. Has FCC staff increased or decreased since 1980 and in which areas of expertise?

Major Contributors to This Report

Resources, Community, and Economic Development Division, Washington, D.C.

John H. Luke, Associate Director, (202) 275-6111
Ron Wood, Group Director
Thomas A. Heck, Project Manager
John P. Scott, Evaluator
Peter J.D. Espada, Evaluator
M. E. Hampton, Evaluator
Wendy T. Holmes, Typist

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