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May 31, 1994

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Mr. David L. Rauch  
Executive Secretary  
Missouri Public Service Commission  
P. O. Box 360  
Jefferson City, MO 65102

RE: Case No. TO-94-184 - In the Matter of the investigation into  
Southwestern Bell Telephone Company's affiliate transactions

Dear Mr. Rauch:

Enclosed for filing in the above-captioned case is an original  
and fourteen (14) conformed copies of a **COMMENTS OF THE STAFF OF  
THE MISSOURI PUBLIC SERVICE COMMISSION ON THE SCOPE OF THIS DOCKET.**

This filing has been mailed or hand-delivered this date to all  
counsel of record.

Thank you for your attention to this matter.

Sincerely,

*Thomas R. Schwarz, Jr.*  
Thomas R. Schwarz, Jr.  
Senior Counsel  
314-751-5239

TRS:bac  
Enclosures

cc: Counsel of Record

**FILED**

**MAY 31 1994**

**MISSOURI  
PUBLIC SERVICE COMMISSION**

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

In the matter of the investigation into )  
Southwestern Bell Telephone Company's )  
affiliate transactions. )

Case No. TO-94-184

**FILED**

MAY 31 1994

**COMMENTS OF THE STAFF  
OF THE MISSOURI PUBLIC SERVICE COMMISSION  
ON THE SCOPE OF THIS DOCKET**

MISSOURI  
PUBLIC SERVICE COMMISSION

In response to the Missouri Public Service Commission's ("Commission") order of March 30, 1994, the Staff of the Commission respectfully submits the following with regard to the scope of this docket.

**I**

The Staff considers that the Commission's language in the Report and Order in docket TC-94-224 ("the R&O") suggests undertaking a detailed, in-depth examination of the transactions between Southwestern Bell Telephone Company (SWBT) and its affiliated companies, including its parent Southwestern Bell Corporation ("SBC"). Such an undertaking would entail review of FCC orders, rules and regulations; review of SWBT's Cost Accounting Manual ("CAM") for compliance with the FCC mandate; review of FCC procedures to ensure that they adequately safeguard against inter- and intra-company pricing abuses; and review of SWBT's implementation of its CAM to insure compliance therewith. Specifically, the Staff suggests the scope of this docket, as the Staff understands the Commission's proposal, to be:

A. Review of the cost separations process between regulated and non-regulated activity at SWBT is appropriate in this docket (suggested by Commission concern 4, R&O in TC-93-224, p. 46). Included in this area should be review of SWBT's and any affiliate's Cost Allocation Manuals, as well as any significant modifications. This review should discover if

SWBT's accounting practices comply with FCC procedural requirements (in response to Commission concerns 1 through 4, R&O in TC-93-224, p. 46). This area will also include verification of SWBT's outside auditor's work.

B. An additional task should be to test the reports that quantify the purchase transactions between SWBT and other SBC affiliates. These reports, if accurate, should be used to determine material SWBT affiliate purchases. The anticipated materiality standard for affiliated purchases should be transactions with an affiliate totalling more than \$500,000 per year, plus any other purchases needed to ensure that 90% of total purchase transactions will be examined, exclusive of purchases from Bellcore. Although there should be some examination of Bellcore transactions in order to determine if any duplication exists with purchases from Technical Resources, Inc. (TRI), a direct audit of Bellcore would require a costly, extensive out-of-state commitment and is not anticipated at this time.

C. A further area of review should be a detailed inquiry into the procedures and documentation by both SWBT and its affiliates for material transactions between and among themselves. This should include review of: 1) SWBT costing practices and market pricing references used in sales to affiliates; 2) pricing procedures of affiliates in sales to SWBT and market pricing references in such transactions; 3) use of pass-through transactions between and among affiliates; 4) transactions between affiliates (other than SWBT) that affect SWBT's cost of service (Example: Yellow Pages/ Gulf Printing). This area of review should include verification that SWBT and its affiliates use the same cost components in pricing affiliate transactions (in response to Commission concerns 5 through 6, R&O in TC-93-224, pp. 47 and 67).

D. Another area of inquiry should be sampling and testing for compliance with the appropriate standards. This should include transactions directly between SWBT and its affiliates, as well as transactions between affiliates which are subsequently charged to SWBT (In response to Commission concerns 1 through 6, R&O , pp. 46-47 and p. 67).

E. The Staff's review of the joint FCC/Five-state audit report ("Joint Audit Report") concerning SWBT affiliated transactions which was released May 22, 1994, indicates that the Joint Audit Report will be of limited use in resolving the specific matters which the Commission has suggested be examined in this docket. The Staff interprets the Commission's language in the R & O as suggesting a detailed review of SWBT's affiliated transactions processes in this docket, but the Joint Audit Report reflects a limited and less detailed review of SWBT's affiliate transactions, focusing on whether SWBT's accounting practices are in accord with FCC rules, without expressing any opinion as to whether the FCC rules are sufficient to prevent possible affiliate transaction abuses.

Moreover, most of the specific questions the Commission posed in the R&O were not part of the scope of the joint audit. For example, the Commission indicated an interest in whether the FCC's acceptance of fully distributed costs (FDC) studies, in lieu of prevailing market price, to determine price for services bought and sold by affiliates constitutes a "loophole" in the affiliate transactions standards. The Joint Audit Report did not express an opinion on the subject. The R&O referenced an interest in comparing costing procedures for affiliate transactions with those used for regulated/non-regulated allocations. Generally, the Joint Audit Report does not address regulated/non-regulated allocations. The Commission in the R&O indicated a concern with the data and methodology used to prepare FDC and market price studies. The Joint Audit

Report expressly states that it gives no opinion on FDC methodology, and no information is provided concerning the adequacy of market price studies. The R&O expresses an interest in exploring affiliated transactions involving Yellow Pages, and the Joint Audit Report does not address any Yellow Pages issues.

For these reasons, the Staff believes that the Joint Audit Report, in and of itself, does not address the concerns of the Commission in establishing this docket.

F. It appears to the Staff that this investigation can lead only to the production of a report recommending possible additional standards, procedures, or documentation for transactions between SWBT and its affiliates and/or cost allocations between regulated and non-regulated activities. Since there is no likely vehicle for review and enforcement in the foreseeable future, the docket would result in being essentially a rigorous, expensive academic exercise involving considerable Staff resources.

G. The Staff estimates that conduct of an investigation outlined here will require the attention of four of its senior auditors on essentially a full time basis for approximately one year. The Staff cannot estimate the resources needed by the other parties, but expects that they would be substantial.

H. The Staff recommends that the Commission not set a procedural schedule in this docket until at least thirty days after it defines the scope of this docket. The parties can use such a time period to evaluate the resources presently available to them; the additional resources needed to accomplish the scope set by the Commission; and other procedural concerns that may arise.

## II.

In lieu of the formal investigation of affiliated transactions of SWBT as discussed in Part I of this response, the Staff recommends the Commission close this docket in favor of an informal investigation and education process on the issue of affiliate transactions.

A. Affiliated transactions between regulated utilities and non-regulated parent or sister corporations now occur in most types of utilities. Local exchange companies ("LECs"), including but not necessarily limited to SWBT, GTE and United, routinely have transactions with parent and sister corporations, and conduct both regulated and non-regulated business within the telecommunication companies themselves. Alliances between LECs and cable television operations, which may pose similar affiliate problems, appear to be on the horizon. Increasingly, water companies have parent corporations with which they have dealings incident to the provision of utility service.<sup>1</sup> Gas local distribution companies (LDC's) may be purchasing gas from marketing or transportation affiliates<sup>2</sup>. Electric utilities are establishing affiliated corporations for generating and other purposes.<sup>3</sup> Missouri Public Service, wholly owned by UtiliCorp United, Inc., also presents a parent company cost-allocation situation.

B. Given the prevalence of parent company cost allocations in Missouri utilities, the narrow focus of this docket on SWBT may unduly limit the scope of the issues examined. Examination of the procedures used by other utility groups to allocate parent company costs may

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<sup>1</sup>For example, St. Louis County Water Company, Missouri-American Water Company, and Capital City Water Company are owned by holding companies and parent company costs are examined by the Staff in these utilities' rate proceedings.

<sup>2</sup>This situation exists with respect to Associated Natural Gas Company.

<sup>3</sup>Kansas City Power & Light Company has recently announced the formation of an affiliated corporation, KLT, Inc.

provide a better opportunity for a systematic review of the issues that need to be addressed in order to eliminate, or at least mitigate, subsidization of unregulated activities by regulated activities. Further, a broader study could lead to a generic policy formulation by the Commission to deal with the issues posed by the affiliate transactions of all regulated utilities.

C. An informal setting would provide greater opportunity for the Commission, its individual members, the Staff and other participants to get answers to particular concerns. The procedural restrictions imposed by the Commission's rules in docketed cases may hamper direct communication by the Commission to the interested parties of the Commission's interests and questions. An informal setting, in which the Commission can directly interact with the affected parties is more likely to facilitate general policy formulation. Such a process can serve as the basis for a rulemaking if the Commission deems it appropriate, which an investigation of SWBT would not.

D. Finally, an informal, general setting may help avoid discovery problems which the Staff anticipates would impede an affiliate transactions investigation focused solely on SWBT.

E. The Staff suggests that the nature, content and timing of an informal process be the subject of discussion at the prehearing conference scheduled in this docket on June 21, 1994.

Respectfully submitted,

*Thomas R. Schwarz, Jr.*  
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**CERTIFICATE OF SERVICE**

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 31st day of May, 1994.

Thomas R. Schweng Jr.



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