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October 24, 1997

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FILED

OCT 24 1997

MISSOURI
PUBLIC SERVICE COMMISSION

Mr. Cecil I. Wright
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. Wright:

Enclosed for filing in the above-captioned case are an original and fourteen (14) conformed copies of a **REPORT ON AFFILIATE TRANSACTION MEETING**.

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

Thank you for your attention to this matter.

Sincerely yours,

Thomas R. Schwarz, Jr.
Thomas R. Schwarz, Jr.
Deputy General Counsel
573-751-5239
573-751-9285 (Fax)

TRS/vf
Enclosure
cc: Council of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

FILED
OCT 24 1997

MISSOURI
PUBLIC SERVICE COMMISSION

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

REPORT ON AFFILIATE TRANSACTION MEETING

COMES NOW Southwestern Bell Telephone Company (SWBT), the Staff of the Missouri Public Service Commission (Staff) and Office of Public Counsel (OPC) and state as follows:

I. BACKGROUND

On February 16, 1995, SWBT, Staff and OPC entered into a Stipulation and Agreement under which the parties agreed to convene a "pre-audit" conference to discuss SWBT-specific issues regarding affiliate transactions. The parties had agreed that the structure for a "pre-audit" conference should contain twelve items. On September 25 and 26, 1997, a conference was held in St. Louis among the parties to discuss the twelve procedures contained in the Stipulation and Agreement.

II. COMPLETION OF TWELVE PROCEDURES

Pursuant to the February 16, 1995 Stipulation and Agreement, SWBT presented, discussed and reviewed the twelve procedural items agreed upon among the parties as the items to be included for the conference as follows:

1. Copies of all affiliate purchases and sales contracts for the test period will be provided.

These purchases and sales contracts will be indexed by year and by affiliate company. Three volumes of contracts were provided by SWBT, two for sales and one for purchases.

2. Reports containing the revenue and/or expenses of purchases from and sales to affiliates, by affiliate, for the test period will be provided.

SWBT provided and discussed the following information:

- **Fully Distributed Cost Reports which display the Missouri costs associated with services provided to affiliates.**
- **Contribution Reports reflecting Missouri revenues received by affiliate, by service.**
- **For purchases from affiliates, both Missouri and total SWBT reports were provided from SWBT's Affiliate Transaction Processing System (AFTRAN), which details payments to affiliates by Part 32 account.**

3. **Review of existing FCC affiliate transaction rules with emphasis on any significant changes since the last audit with the opportunity for direct interview by Staff of SWBT subject matter experts. This review will include an overview of what constitutes audit compliance of sales of services to affiliates. Purchases of services from affiliates will be outlined by type of affiliate: i.e., cost allocation, prevailing prices, etc.**

SWBT presented both an overview of FCC rule changes for affiliate transactions as outlined in CC Docket 96-150 as well as procedural changes made at SWBT to comply with the new rules. Primary changes include implementation of a 50% sales quantity threshold to third parties in order to establish a prevailing market price, and the introduction of a requirement for services provided between affiliates to be valued based on a comparison of fully distributed cost and fair market value. Fully distributed cost remains the pricing methodology for affiliates that exist solely to provide services to members of the corporate family. SWBT also reviewed affiliate transaction impacts of the merger with Pacific Telcelia. The remaining questions above were addressed as part of the sales and purchases audit trail presentation below.

4. Review with staff auditors the following sections of the Cost Allocation Manual:

- a. Section IV - Chart of affiliates
- b. Section V - Transactions with affiliates

SWBT reviewed both format and content of the Chart of Affiliates and Affiliate Transaction sections of SWBT's Cost Allocation Manual (CAM). The CAM identifies and describes the affiliates and the transactions including pricing terms between SWBT and each of its affiliates.

5. Review any significant operational changes to the purchases or sale of services to affiliates since the last audit.

Operational changes were covered in Item 3.

6. Provide copies of any SWBT compliance reviews of purchases from affiliates conducted during the test period. SWBT agrees to perform and provide compliance reviews for its transactions with Southwestern Bell Communications (SBC).

Due to their voluminous nature, SWBT made purchases compliance reviews available for on-site inspection and provided a copy of its formal compliance review summary document for purchases with each of the affiliates listed below. SWBT further provided oral overviews of the compliance review process for each of the major affiliates.

SBC Management Services, Inc. (parent company)
Southwestern Bell Communications, Inc.
Southwestern Bell Technology Resources, Inc.
Southwestern Bell Yellow Pages, Inc.
SBC Asset Management, Inc.

**Southwestern Bell Mobile Systems, Inc.
Southwestern Bell Telecommunications, Inc.
AMDOCS (available through E&Y audit)**

- 7. Provide copies of any SWBT internal audits of affiliate transactions conducted during the test period. SWBT affiliate services group will coordinate with the SBC internal audit group to schedule timely audits of SBC and Yellow Pages prior to next complaint case.**

Copies of both internal and external audits were provided by SWBT.

- 8. Provide the cost/price worksheets for sales of services to affiliates only for the test period. These worksheets will include incremental unit cost, fully distributed cost and price for each billing element.**

SWBT provided the information as requested. The cost/price worksheets are part of SWBT's audit trail for sales to affiliates. Price is compared to incremental cost by service to review the benefit to SWBT of providing the service. Price is further compared to fully distributed cost, at the unit level, to ensure that all elements of pricing meet the FCC affiliate transaction rules.

- 9. Respond to specific questions concerning tariff sales or prevailing price sales to affiliates, with the understanding that affiliated companies receive tariffed and prevailing price services under the same terms and conditions as similar non-affiliated companies.**

All questions were answered. No outstanding responses are due.

- 10. Present to staff auditors an overview of the audit trail for the purchases from the major affiliates (SBC, Yellow Pages, Telecom, Mobile Systems).**

The audit trail for the major affiliates will include time reporting, as appropriate, cost allocation, prevailing price review, etc.

SWBT presented overviews of the audit trails for the major affiliates. Among the audit trail items discussed were the time reporting process for the various affiliates and SWBT's validation of affiliates' time reporting through compliance review procedures.

Where SWBT purchased services at fully distributed cost, SWBT provided and/or discussed the affiliate's cost allocation procedures. SWBT explained how the compliance review results confirms the propriety of the affiliate's procedures and resulting charges to SWBT by tracing the costs used in development of the price charged SWBT to the affiliate's financial statements.

Similarly, SWBT demonstrated how its compliance reviews substantiate the existence of prevailing market prices for products and services provided to SWBT at a prevailing market price. SWBT reviews affiliate third-party sales records to confirm that prevailing price criteria are met.

11. Present to staff auditors an overview of sales to the major affiliates. The audit trail will include a cost studies overview, pricing, billing, etc.

SWBT's presentation of its audit trail for sales to affiliates included review of the request for new service from the SWBT service provider, cost study request and results, executed billing schedule and pricing addendum, customer bill creation and revenue journalization. Subsequent to the conference, SWBT provided further documentation of the audit trail for fully distributed cost studies to substantiate that all SWBT journal costs are included in the studies.

12. Answer any remaining instant audit trail process questions that Staff Auditors may have.

All questions answered. No outstanding responses.

III. RESULTS OF TWELVE ITEM REVIEW

SWBT demonstrated that it maintained sufficient audit trails for sales to and purchases from affiliates. All sales and purchase transactions with affiliates are supported by written contracts which provide the basis for continued oversight and define the relationship, including pricing, between SWBT and the affiliate.

For purchases from affiliates, SWBT demonstrated that its audit trail includes concise accounting by affiliate and by account through its Affiliate Transaction Processing System which provides the basis for regulatory reporting. SWBT further demonstrated that it performs and documents sufficient internal compliance reviews to reinforce its compliance with both the contract and specific purchase transactions of the FCC affiliate transaction rules. SWBT confirms that affiliates' billings to SWBT reflect development of fully distributed costs consistent with its interpretation of FCC guidelines and traces such costs to affiliates' financial statements. For services purchased at prevailing price, SWBT analyzes affiliates' third party sales records to ensure prevailing price criteria are met.

For sales to affiliates, SWBT demonstrated that it produces and maintains documentation to support its pricing. SWBT's audit trail for each item sold to an affiliate includes the calculation and maintenance of incremental unit cost, fully distributed cost, price and units sold.

As part of SWBT's audit trail for sales to affiliates, price is compared to incremental cost by service to review the benefit to SWBT of providing the service. Price is further compared to fully distributed cost, at the unit level, to ensure that all elements of pricing meet the FCC affiliate transaction rules. Management oversight reports are produced which track units sold as well as revenues and contribution by service and state.

SWBT agreed to file annually, as public documents, with the Missouri Public Service Commission:

- **A copy of SWBT's Cost Allocation Manual (CAM) which identifies and describes transactions between SWBT and affiliates**
- **Attestation letters of the external auditors regarding their annual CAM audit.**
- **Results of joint federal/state biennial audits as required by Section 272 of the 1996 Telecommunications Act. (The Act requires the auditor to provide results to state commissions to be made publicly available.)**
- **OPC and Staff will review the external auditor attestation and work papers each year, if necessary.**

Staff and OPC had previously identified three issues in SWBT's affiliate transaction practices that were reviewed during this conference. SWBT's responses are outlined below:

- 1) Time reporting documentation for Southwestern Bell Corporation personnel. SWBT stated that its in-depth review of its internal compliance review controls and procedures for SBC Management Services, Inc. (MSI) time reporting procedures assure that sufficient time reporting documentation exists.**
- 2) Inclusion of all relevant costs in converting incremental costs to fully distributed costs. Both during the conference, and in follow-up documentation, SWBT provided documentation of its audit trail of FDC studies supporting sales to affiliates which, SWBT asserted, demonstrates that all SWBT costs are included in the studies.**
- 3) Standard for determining market prices to affiliates. SWBT has implemented the revised market price standard promulgated by the FCC in CC Docket 94-150, which requires that more than 50% of an affiliate's**

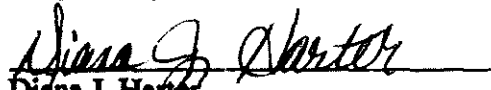
sales quantity must be to non-affiliated third parties in order to establish a prevailing market price.

IV. CONCLUSION

Based upon compliance with the terms of the February, 1995 Stipulation and Agreement, the parties believe that the Missouri Public Service Commission (PSC) should close this docket.

WHEREFORE, the parties request that the PSC close this docket.

Respectfully submitted,


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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing document were served to all parties on the attached Service List by first-class postage prepaid, U.S. Mail on October 24, 1997.

Thomas E. Schwegel Jr.

Service List For Case No. TO-94-184
Updated October 24, 1997

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