



October 20, 1994

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Mr. David Rauch  
Executive Secretary  
Missouri Public Service Commission  
301 West High Street, Suite 530  
Jefferson City, MO 65101

Re: Case No. TO-94-184

Dear Mr. Rauch:

Enclosed for filing with the Commission in the above-referenced case is the original and fourteen copies of Southwestern Bell Telephone Company's Position on Issues Concerning Affiliate Transactions.

Please stamp "Filed" on the extra copy and return to me in the enclosed self-addressed, stamped envelope.

Thank you for bringing this matter to the attention of the Commission.

Sincerely,

A handwritten signature in cursive script that reads "Diana J. Harter".

Diana J. Harter

Enclosures

CC: Parties of Record

**FILED**

OCT 21 1994

MISSOURI  
PUBLIC SERVICE COMMISSION

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X

**BEFORE THE MISSOURI 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

**SOUTHWESTERN BELL TELEPHONE COMPANY'S  
POSITION ON ISSUES CONCERNING AFFILIATE TRANSACTIONS**

**FILED**  
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MISSOURI  
PUBLIC SERVICE COMMISSION

On September 13, 1994, the Commission issued an Order Establishing Dates for Filing of Parties Positions (Order Establishing Dates). In that Order, the Commission asked the parties to file their positions on the proper standards to apply for determining the reasonableness of affiliate transaction costs and the necessary procedures to insure compliance with such standards. The Commission also directed the parties to file their positions concerning the necessary components of an audit trail.

Southwestern Bell Telephone Company (SWBT) believes that the Commission should hold this docket in abeyance until the Federal Communications Commission (FCC) issues an order in the pending Notice for Proposed Rulemaking (NPRM) in CC Docket 93-251. The FCC is reviewing potential affiliate transaction rule modifications concerning, in part, whether a fair market valuation process is appropriate. As stated in the joint Report of the Parties filed on August 24, 1994 in this docket, the existing Commission rules adopt FCC Part 32 which set forth the standard for affiliate transactions. The Commission should

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consider the FCC's upcoming order and any resulting affiliate transaction rule modifications prior to deciding whether to modify its own rule adopting the FCC's standard. Furthermore, any Commission decision to change its affiliate transaction standard should not occur in a docket limited to SWBT. Any affiliate transaction standard should be applicable to all local exchange companies, and possibly all utilities, and should therefore be addressed in a more generic docket or rulemaking proceeding. SWBT would challenge any affiliate standard that would be applied only to the Company, particularly if such standard is more burdensome than that applied to other utilities, particularly other local exchange companies.

The Commission has agreed in the Stipulation and Agreement entered in Case No. TO-90-1 which was executed on August 31, 1994, that it would not initiate or support a complaint regarding SWBT's earnings prior to January 1, 1999. The Commission should hold this docket in abeyance until an earnings complaint, if any, becomes more imminent. As the industry changes, SWBT's relationship with its affiliates and the affiliates' structure is likely to change also. In an ever-changing telecommunications industry, it may be a waste of resources to establish new procedures regarding affiliate transaction standards several years prior to the actual review.

SWBT proposes that further Commission action in this docket be deferred until some of the uncertainty as to the FCC rules on affiliate transactions and SWBT's future affiliate relationships

is removed. However, in an effort to respond to the issues raised by the Commission, SWBT has reviewed the open issues from TC-93-224, et al, as well as those issues to be addressed as a result of the June 21, 1994 Prehearing Conference in TO-94-184 and the Order Establishing Dates.

This report will address the open issues from TC-93-224, et al., the three areas identified during the Prehearing Conference in TO-94-184, the areas addressed in the Order Establishing Dates and will suggest a procedure for setting the basis for future reviews of SWBT's affiliate transactions.

#### SECTION A

**IS SWBT COMPLYING WITH THE FCC COST ALLOCATION RULES AND HAVE THE SIX QUESTIONS [from TC-93-224, et al] LISTED IN THE REPORT AND ORDER BEEN ADDRESSED?**

SWBT believes it is in compliance with the FCC cost allocation rules. SWBT further feels that the six questions listed in the Report and Order have been addressed and that a sufficient audit trail has been established for future audit purposes.

The six questions have been addressed in the following manner:

1. Is there a loophole in the FCC acceptance of FDC studies instead of determining prevailing market price for services only bought and sold by affiliates?

**Answer:**

No, SWBT does not believe there is a loophole. In the open and lengthy Joint Cost Order proceeding, the FCC considered

numerous proposals for cost valuation. Several parties argued that, if a tariff or prevailing price is unavailable as a measure of value, the FCC should look to the estimated value of similar services in the marketplace as a valuation standard.<sup>1</sup> The FCC rejected such arguments noting that "such a valuation standard is fraught with the potential for abuse, and would be difficult to monitor."<sup>2</sup> The FCC also correctly observed that the "determination of fair market value raises concerns of subjectivity."<sup>3</sup> The FCC concluded that, in contrast to estimating fair market value, "by requiring carriers and their affiliates to allocate costs pursuant to the cost allocation standards, we can ensure that an auditable measure of the cost of service is available."<sup>4</sup>

The fully distributed cost methodology was not adopted in a vacuum. The conclusion was reached after the introduction and debate of several alternatives with the conclusion that the use of fully distributed cost was the most reasonable safeguard against cross subsidy.

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<sup>1</sup>Joint Cost Recn. Order, 2 FCC Rod at 6297.

<sup>2</sup>Id.

<sup>3</sup>Joint Cost Order, 2 FCC Rod at 1335

<sup>4</sup>Joint Cost Recn. Order, 2 FCC Rod at 6297. The FCC thus rejected the standard of an "estimated fair market value" and instead relied on a hierarchy of 1) tariffed rate, 2) the prevailing price as established by actual sales to nonaffiliated third parties and finally 3) fully distributed cost, noting that all are easily auditable and do not require subjectivity. See, Joint Cost Recn. Order, 2 FCC Rod at 6296-6297.

Additionally, in CC Docket 90-623 the FCC stated, "We conclude that our comprehensive system of cost accounting safeguards has worked well and, as strengthened above, effectively protects ratepayers against cross-subsidization by the BOC's."<sup>5</sup> The FCC further concluded that, the affiliate rules are geared to protect ratepayers and that with the rules, the "activity bears not just its incremental costs for asset and service transfers but general overhead costs as well, which would otherwise be solely borne by regulated ratepayers."<sup>6</sup>

The experience in the last two SWBT rate cases in Missouri demonstrates the subjectivity that mandating estimated fair market value would bring to the regulatory process. What is the fair market value (single amount)? In a range of prices for a service, what is the proper amount to pick? Are the services comparable? The whole question boils down to choosing between various estimates of fair market value, which is a highly subjective process.

Finally, this question would involve modification of an FCC approved method of analyzing affiliate transactions. This is not the appropriate forum for such a change. The FCC currently has a Notice for Proposed Rulemaking (NPRM), CC Docket 93-251, that is exploring the potential modification of the existing affiliate transaction rules, including the question of whether a fair

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<sup>5</sup>CC Docket 90-623, Page 21, Para. 44.

<sup>6</sup>CC Docket 90-623, Page 22, footnote 55

market valuation process is appropriate. That FCC proceeding is the appropriate forum in which to address this question.

2. Use of revenues by SWB to develop its general expense factor;

**Answer:**

Question 2 dealt with the "use of revenues by SWB to develop its general expense factor." Mr. Lundy's testimony in TC-93-224, pages 23-24, clarified TAI's misinterpretation of the calculation and appears to have answered TAI's question. General Expenses in the fully distributed cost studies are assigned based on a relationship of common cost to total cost in compliance with the fully distributed cost (FDC) rules.

Further, TAI identified a revenue allocation used by the Hotel Majestic. TAI, the Staff's consultant in Case No. TC-93-224., et al, and the Citizens' Utility Ratepayer Board's (CURB) consultant in Kansas, has represented to the Kansas Corporation Commission (KCC) that this problem has been corrected.<sup>7</sup>

Finally, SWBT supplied the Hotel Majestic compliance review to Staff in response to questions submitted to SWBT after the June 21, 1994 Prehearing conference. That review shows revenues are no longer used in calculating the general factor.<sup>8</sup>

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<sup>7</sup>Docket No. 187,730-U, Review and Recommendation of the Citizen's Utility Board Concerning A Successor Plan to TeleKansas, Page 25, Para. 40.

<sup>8</sup>Revenue allocation does have some limited application in the assignment of certain sales costs at Yellow Pages, for the White Pages Directory fully distributed cost study. In the Yellow Pages cost context, revenue is the most accurate direct measure of cost

**3. Failure to assign administrative costs to some affiliate transactions;**

**Answer:**

SWBT's FDC studies were reviewed in the joint staff audit of affiliate transactions in which auditors from the FCC, Missouri, Arkansas, Kansas, Oklahoma and Texas commission staffs participated. That audit did not uncover any underlying problems with the fully distributed cost studies or the assignment of administrative costs associated with SWBT's sale of affiliate services, and dealt with an audit sample of 65% of such transactions over a four year period (1989 through 1992). Page D-54 of the joint staff audit report identified the scope of that audit as follows:

The audit team's analyses encompassed contract management, service cost studies and pricing, tracking of billing units, accounting and billing. More specifically,

- We reviewed internal and external audit reports related to affiliate transactions.
- We reconciled affiliate transactions data provided to the audit team to Form N Report for 1991 and 1992 and to the General Ledger.
- We reviewed SWBT's written policies and procedures related to affiliate transactions.
- We reviewed service agreements and pricing addenda.
- We reviewed relevant sections of the Cost Allocation Manual (CAM) dealing with affiliate transactions.

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allocation and to SWBT's understanding is in compliance with FDC rules. Note: This is not a general expense allocation.



- We reviewed costing of services to ensure that all direct and indirect costs were included. [FDC Review].
- We reviewed internal controls related to SWBT's provision of affiliate services.
- We reviewed the pricing of assets sold to affiliates.
- We tested billings to affiliates and the recording of the revenues.

The conclusion reached by the audit as written on Page D-59 of the report was:

Based on the audit work performed, nothing came to the attention of the audit team that would indicate that SWBT's nontariffed services rendered to affiliates and sales of assets to affiliates were not accounted for in a manner consistent with the applicable FCC affiliate transactions standards. Furthermore, nothing came to the attention of the audit team that would indicate that the telephone ratepayers had been adversely affected by transactions between SWBT and affiliates for noncompliance with these standards.

Based on the joint audit conclusion, SWBT believes that it is in compliance with the FCC rules and that no further action need be taken with respect to the assignment of costs in its FDC studies.

4. The use of different costing procedures for affiliate transactions and those used for allocations between regulated and nonregulated operations;

**Answer:**

SWBT does not use different costing procedures.

Furthermore, as pointed out in response to 3, above; the joint staff audit found SWBT's sales to affiliates to be in compliance with the FCC's rules. The joint audit did raise two questions

- We reviewed costing of services to ensure that all direct and indirect costs were included. [FDC Review].
- We reviewed internal controls related to SWBT's provision of affiliate services.
- We reviewed the pricing of assets sold to affiliates.
- We tested billings to affiliates and the recording of the revenues.

The conclusion reached by the audit as written on Page D-59 of the report was:

Based on the audit work performed, nothing came to the attention of the audit team that would indicate that SWBT's nontariffed services rendered to affiliates and sales of assets to affiliates were not accounted for in a manner consistent with the applicable FCC affiliate transactions standards. Furthermore, nothing came to the attention of the audit team that would indicate that the telephone ratepayers had been adversely affected by transactions between SWBT and affiliates for noncompliance with these standards.

Based on the joint audit conclusion, SWBT believes that it is in compliance with the FCC rules and that no further action need be taken with respect to the assignment of costs in its FDC studies.

4. The use of different costing procedures for affiliate transactions and those used for allocations between regulated and nonregulated operations;

Answer:

SWBT does not use different costing procedures.

Furthermore, as pointed out in response to 3, above; the joint staff audit found SWBT's sales to affiliates to be in compliance with the FCC's rules. The joint audit did raise two questions

regarding SBC allocations, and one question regarding the allocation of costs from AMI. These three issues involve a difference of interpretation of the FCC rules and are currently being reviewed by the FCC.

For the remaining affiliate transactions for which fully distributed cost rules apply, the joint staff audit had no negative comment. Regarding the fully distributed cost studies associated with SWBT's sale of affiliate services, the joint staff audit report concluded that:

nothing came to the attention of the audit team that would indicate that SWBT's nontariffed services rendered to affiliates and sales of assets to affiliates were not accounted for in a manner consistent with the applicable FCC affiliate transaction standards. Furthermore, nothing came to the attention of the audit team that would indicate that the telephone ratepayers had been adversely affected by transactions between SWBT and affiliates for noncompliance with these standards.

5. Failure to provide the underlying data for FDC and market price studies.

Answer:

SWBT has provided sufficient underlying data for its FDC cost studies in the TC-93-224 audit, the joint FCC/State audit and the Kansas audit. As stated in 4 above, the joint audit report had no negative comment concerning fully distributed cost studies, and current FCC rules do not require market price studies. Therefore, SWBT has accounted for affiliate transactions in a manner consistent with the applicable FCC affiliate transaction standards which have been adopted by the Commission.

6. Would the price of market studies outweigh the benefit from the results of these studies?

**Answer:**

Yes. This question was recently asked by the FCC and answered by SWBT and the rest of the industry in response to the FCC Notice for Proposed Rule Making, CC Docket 93-251. SWBT, as did the industry, concluded that the FCC was correct in its assessment in the Joint Cost Order that market studies were subjective and difficult to monitor, and would result in increased cost without customer benefit. The net result of mandated market studies is to increase affiliate oversight cost without an attendant increase in revenue or contribution, which would increase the upward pressure on local service rates.

Additionally, due to the significant problems associated with estimated fair market valuations as noted in response to question 1 above, the customer is negatively impacted by increased administrative cost and is not benefitted by the results of the studies causing the costs. SWBT's estimated annual cost for full implementation was \$3.5M for SWBT's sale of services to affiliates and \$2.4M for SWBT's purchases from affiliates. SWBT's costs were in line with those filed for the rest of the industry. (SWBT Comments CC Docket 93-251, page 25)

Further, the use of an estimated fair market valuation would create a unique rule for SWBT only in Missouri and would be inconsistent with existing FCC rules. SWBT's affiliate transactions have been exhaustively reviewed and it has been determined that SWBT is in almost all respects following the

existing FCC affiliate transaction rules. In those few cases in the joint staff audit where questions have been raised concerning rule interpretation, the FCC's own review has not been concluded, and the issues will be addressed in that forum.

Although SWBT believes it is in compliance with the applicable FCC standards, as part of Section C of this report, SWBT proposes a twelve point process to streamline any future audit of SWBT's affiliate transactions and to establish the standard for that audit.

#### SECTION B

HAS THE JOINT AUDIT OR THE KCC AUDIT RESOLVED THE SIX QUESTIONS OR ADEQUATELY ADDRESSED THE ISSUE OF COMPLIANCE WITH THE FCC'S RULES.

As discussed in greater detail in Section A, SWBT believes that the issues have been adequately addressed and answered. SWBT is in compliance with the FCC rules for affiliate transactions as they have been written and issued by the FCC. There are a limited number of issues where SWBT and the joint staff audit disagree on the interpretation of the FCC rules, and those questions will be resolved by the FCC. SWBT further believes that the Federal affiliate transaction rules as written and issued by the FCC should be the basis for any audit of SWBT's affiliate transactions.

An issue that was also raised by TAI in TC-93-224 involved the audit trail associated with affiliate transactions. SWBT believes this issue has also been resolved. CUB's consultant,

TAI, in Kansas stated that SWBT has made good progress in complying with the requirements of its CAM and that "Of major importance in this regard, SWBT now appears to be able to provide the 'audit trail' documenting its affiliate transactions."

Further, the joint staff audit utilized much of the same data as Kansas in its audit of affiliate transactions and did not identify any major issues. To further substantiate this conclusion, SWBT provided to the Missouri staff, subsequent to the Prehearing conference, the detail associated with the audit trail, as well as, the Data Request material used in Kansas. Attached in support of this filing is the summary of the examples provided to staff, as well as, an index of the Kansas Data Requests.

As outlined in Section C, SWBT is recommending a pre-audit conference in advance of any future Missouri affiliate transactions audit to facilitate staff's review of the detailed affiliate transaction data.

### SECTION C

**DETERMINE WHETHER THERE IS A METHOD OF REVIEWING SWBT'S AFFILIATE TRANSACTIONS SO THAT THE COMMISSION CAN DETERMINE WHETHER SWBT IS IN COMPLIANCE WITH WHATEVER STANDARD IS IN EFFECT.**

SWBT agrees with the Report of the Parties filed on August 21, 1994, regarding the accounting definition of an audit trail. As indicated in the attached Exhibits, SWBT has such an audit

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<sup>1</sup>Docket No. 187,730-U, Review and Recommendation of the Citizen's Utility Board Concerning A Successor Plan to TelsKansas, Page 24, Para. 38.

trail and submits this is the appropriate definition of an audit trail for this docket.<sup>10</sup> Further, SWBT submits that the audit trail also includes the application of Part 32 affiliate transaction rules and that these rules are the appropriate standard to be used to measure compliance and safeguard against cross-subsidization. But, SWBT recognizes that there are many changes taking place that could impact affiliate transactions. As mentioned above, the FCC has an open NPRM dealing with the affiliate transaction rules.

SWBT submits that the following structure for a pre-audit meeting and the information provided at that time will help ensure that the Staff has the latest FCC guidelines and SWBT audit trail data. The review of this data will allow the Staff to determine if SWBT is in compliance with the FCC's affiliate transaction rules which should remain the appropriate audit standard. Further, the pre-audit meeting will allow SWBT to update staff on any new affiliate relationships, FCC rules, or other items that have impacted affiliate transactions.

The following twelve points outline the contents of a pre-audit meeting that could be conducted at the inception of any future affiliate services audit.

- Copies of all affiliate purchase and sales contracts for the test period will be provided. These purchase

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<sup>10</sup> Case No. 70-94-184, Report of Parties, C.I. "In a strict accounting sense, an audit trail consists of all accounting documents and records prepared as transactions are processed from origin to final posting. Source documents, journals, and ledgers are the main elements in the audit trail. . ."

and sales contracts will be indexed by year and by affiliate company.

- Reports containing the revenue and/or expense of purchases from and sales to affiliates, by affiliate, for the test period will be provided.
- 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 Company 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 price, etc.
- Review with the Staff Auditors the following sections of the Cost Allocation Manual
  - a. Sections IV - Chart of Affiliates
  - b. Section V - Transactions with Affiliates
- Review any significant operational changes to the purchase or sale of services to affiliates since the last audit.
- Provide a list of any SWBT compliance reviews of purchases from affiliates conducted during the test period.
- Provide a list of any SWBT internal audits of affiliate transactions conducted during the test period.
- Provide the cost/price worksheets for sales of services to affiliates for the test period. This worksheet will include incremental unit cost, fully distributed cost and price for each billing element.
- 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.
- Present to the Staff Auditors a specific sales transaction example from initial service provider input to billing of units consumed by the affiliate company for a specific calendar year during the test period.



- Present to the Staff Auditors one specific purchase transaction for each type from initial contract/agreement, to invoice, to compliance review, to final booking of expense.
- Answer any remaining instant audit trail process questions that Staff Auditors may have.

SWBT believes that the questions raised by the Commission's Report and Order concerning SWBT's compliance with the FCC's affiliate transactions rules have been addressed in the subsequent KCC proceeding or by the conclusions of the joint audit report regarding SWBT's compliance. Although there are some exceptions involving disputes regarding interpretation of such rules, SWBT believes that it has complied with the FCC rules, and that, unless the rules are changed, there should be no reason for this inquiry to continue, particularly at this time. SWBT recognizes that the staff may not fully agree. However, SWBT believes that the appropriate forum for changing the FCC's rules is at the FCC, and not in this proceeding. In addition, SWBT is proposing a twelve step process to be applied in any

future affiliate transactions audit. It is the Company's belief that such a process can lead to a more orderly and less contentious review of affiliate transactions issues in any future proceeding.

Respectfully submitted,

SOUTHWESTERN BELL TELEPHONE COMPANY

By

  
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**CERTIFICATE OF SERVICE**

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

Dated at St. Louis, Missouri, the 20th day of October, 1994.

  
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