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May 19, 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. [REDACTED] - 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 are fifteen (15) conformed copies of the Review Of Affiliate Transactions At Southwestern Bell Telephone Company performed by the Five States Regulatory Commissions and Federal Communication Commission Joint Audit Team. This report has been made public by the Federal Communications Commission (FCC).

Copies of this report are being sent this date to all parties of record in Case No. TO-94-184.

Thank you for your attention to this matter.

Sincerely,

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

TRR/ceb
Enclosure

cc: Counsel of Record

24

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**FIVE STATES REGULATORY COMMISSIONS
AND
FEDERAL COMMUNICATIONS COMMISSION
JOINT AUDIT TEAM**

**REVIEW OF AFFILIATE TRANSACTIONS
AT
SOUTHWESTERN BELL TELEPHONE COMPANY**

MAY 1994

FILED
MAY 19 1994
MISSOURI
PUBLIC SERVICE COMMISSION

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PREFACE

This joint audit report on the affiliate transactions of Southwestern Bell Telephone Company (SWBT) is a historical milestone. This is the first truly joint audit of a Regional Bell Operating Company (RBOC) in which the audit team was staffed by auditors from the state commissions in every jurisdiction in which the company provides telephone service and also by auditors from the Federal Communications Commission (FCC).

The concept for performing these joint audits was conceived by the National Association of Regulatory Utility Commissioners (NARUC) Staff Subcommittee on Accounts and adopted by the NARUC Committee on Finance and Technology on November 13, 1991. The FCC and the five state regulatory agencies within SWBT's territory are supportive of the joint audits.

Efforts to organize and solicit auditors to participate in this joint audit began on June 29, 1992. Communication regarding a protective agreement began in July 1992 and a protective agreement was signed by a representative of SWBT on April 19, 1993. The audit team commenced the audit field work on May 17, 1993 in St. Louis, Missouri and completed its audit work and draft report on December 9, 1993. SWBT agreed to reimburse up to \$75,000 for travel expenses incurred by the state auditors. The audit team spent less than \$25,000 for travel expenses in this project.

During the course of this project many concerns and issues were raised by all the parties involved in this undertaking. These concerns and issues were resolved in a professional manner, even though at times they appeared tedious, complex, delicate and required a considerable amount of time. All parties acted in good faith and were willing to compromise for the successful completion of this project.

To accomplish a project of this magnitude it is necessary that the audit manager in concert with all interested regulatory agencies define clearly the audit scope, set milestones, monitor progress, and communicate effectively with all parties concerned and, in particular, with all members of the audit team. In addition, it is necessary to organize a commissioners' oversight committee which will oversee the administration of the project, a legal group which will address the legal issues that arise, and a policy review group which will review all policy issues to ensure consistency with the regulatory positions and operations of each regulatory agency and/or staff. In this audit, all of the above elements were in place.

The joint audit team members have concluded that this audit was an effective and efficient means of conducting a large scale audit. Given the viability and success of this joint audit, the audit team believes that in the future the use of joint audits should be considered in addressing issues common to each of the regulatory jurisdictions.



May 3, 1994

Richard C. Hartgrove
General Attorney

RE: FCC-State Joint Audit Report of Southwestern Bell
Telephone Company's Affiliate Transactions

Southwestern Bell Telephone Company makes no proprietary or confidential claim with regard to any of the information contained in the FCC-State Joint Audit Report or the Joint Audit Team's Reply Comments.

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EXECUTIVE SUMMARY

JOINT AUDIT REPORT

1. This report is the product of a joint audit team comprised of auditors from the regulatory commissions of the states of Arkansas, Kansas, Missouri, Oklahoma, and Texas and auditors from the Federal Communications Commission (FCC). It covers the results of the examination of affiliate transactions at Southwestern Bell Telephone Company (SWBT). SWBT is the telephone subsidiary of Southwestern Bell Corporation (SBC), one of the seven regional telephone holding companies created at the divestiture of AT&T on January 1, 1984. SBC is headquartered in San Antonio, Texas and as of December 31, 1992 employed approximately 60,000 people, had more than \$10 billion in operating revenues, and approximately \$24 billion in assets. SBC provides telephone service, sales of customer premises equipment, yellow page advertising, printing and distribution of telephone directories, wireless communications services, and has investments in several international operations, through many subsidiary companies. Affiliate transactions cover the provision of services and sales of assets between and among sister companies of an affiliated group such as SBC.

2. The objective of this examination of affiliate transactions was, (i) to determine compliance with the affiliate transactions standards and, (ii) to ensure that the telephone ratepayers had not been adversely affected by potential cross-subsidies flowing to nonregulated affiliates as a result of noncompliance with these standards. Cross-subsidies could flow to the nonregulated affiliates in the form of overcharges to the telephone company. Conversely, cross-subsidies could flow to the nonregulated affiliates in the form of undercharges by the telephone company. The FCC recognized that transactions with affiliates may not be conducted at arm's length, therefore, it instituted accounting safeguards (costing standards) to protect the telephone ratepayers. These accounting safeguards were established in CC Docket 86-111, Report and Order, released February 6, 1987, and are contained in the Uniform System of Accounts (USOA) Section 32.27 Transactions with Affiliates and Section 64.901 Allocation of Costs. The audit team employed these accounting safeguards to determine compliance and to gauge the effect of any transgression on the telephone ratepayers. The examination covered the period 1989 - 1992 and included reviews of policies and procedures and tests of selected transactions with particular emphasis on 1992 activities.

3. For the purpose of this audit, the FCC's affiliate transactions standards have been utilized by the auditors of the regulatory agencies of the five states having jurisdiction over SWBT. However, other regulations, statutes, and/or rate-making standards in each of the jurisdictions may impact the determination of the extent to which affiliate transactions will be considered just and reasonable for state rate-making purposes. The audit team did

not review the affiliate transactions for compliance with other applicable standards, if any, and expresses no opinion on compliance with such standards.

4. From the audit work performed, the audit team concludes that the affiliates' dealings with SWBT are not in full compliance with the affiliate transactions standards and, depending on SWBT's earnings and the regulatory process in each regulatory jurisdiction, the telephone ratepayers may have been burdened by a potential \$93.7 million in excess costs resulting from transactions with two of its affiliates: Southwestern Bell Corporation (SBC), the parent company, and Southwestern Bell Asset Management, Inc. (AMI), the real estate affiliate. In addition, the dollar impact resulting from the lack of support for time reporting by SBC cannot be determined. Because of differences in the regulatory process in each jurisdiction, the audit team has chosen not to make any recommendations in this report. Each jurisdiction may take steps as deemed appropriate.

5. The opinions and conclusions stated in this report are those of the audit team and not necessarily those of the individual regulatory commissions participating in this audit. This report has not been presented to the individual regulatory commissions for approval as to the accuracy of the statements contained herein. Authorization to publish this report does not constitute an express or implied decision by the individual regulatory commissions on any of the issues raised by this report.

6. The audit team's conclusions related to SBC, totaling \$92.4 million, include:

(a). No supporting documentation for time charging by SBC's employees. For the most part, the cost allocation system used by SBC to either directly assign or allocate its costs to its subsidiaries is driven by survey time studies. The audit team was not provided and could not review the adequacy of the results of the survey time studies for the audit period 1989 - 1992. Consequently, the audit team could not determine the reasonableness of SBC's expenses charged to SWBT. The audit team was told by a representative of SBC that at one time four-week survey time studies were made, but that none are currently available. Section 32.12(b) of the Uniform System of Accounts for Telecommunications Companies requires, in part, that "...[t]he detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission".

(b). Improper marketing allocator. SBC allocates its indirect marketing costs (those costs that cannot be directly assigned to a subsidiary) by the use of a marketing allocator derived from the sum of SBC's directly-assigned marketing costs to its subsidiaries as well as the direct marketing costs incurred by those subsidiaries. This practice is not in conformance with the regulatory standards and procedures for the apportionment of joint and common costs which require, "...all costs that can be apportioned on the basis of direct assignment or cost causal attribution measures to be so apportioned. Residual marketing expenses will be divided between regulated and

nonregulated activities based on the ratio of the directly assigned and attributable costs". CC Docket 86-111, Report and Order, at paragraph 190. The audit team interprets this rule to mean that only the costs directly assigned and attributed, if any, to the various subsidiaries by the apportioning company should be included in the computation of the marketing allocator. The effect of SBC's misinterpretation of the rule was an additional allocation of \$30.2 million of marketing expenses to SWBT for the years 1989 - 1992. These expenses were then recorded in SWBT's books of record.

(c). Improper general allocator. In the development of the general allocator, SBC excludes the costs that it directly assigns to the stockholders. The audit team believes that this practice is contrary to regulatory costing standards (Section 64.901 Allocation of Costs), which require that the general allocator be computed by using the ratio of all expenses directly assigned or attributed to activities or subsidiaries, including costs assigned to the stockholders. The exclusion of the costs apportioned to the stockholders from the computation of the general allocator generated an additional \$62.2 million of costs allocated to SWBT for the years 1989 - 1992. These costs were then recorded in SWBT's books of record.

7. The audit team's conclusions related to AMI, totaling \$1.3 million, include:

(a). Office space leased to SWBT at more than prevailing market price. For the period 1989 - 1992, AMI leased office space to SWBT at three locations. At two of these locations, Pinehollow in Houston, Texas and Centerpoint in Arlington, Texas, AMI rented office space to SWBT at fully distributed cost (FDC) when a prevailing market price (PMP) rate had been established. At these two buildings, more than 40% of the total space was rented to nonaffiliated third parties at an average price per square foot lower than that charged to SWBT. This practice is contrary to the affiliate transactions rules which require that rates no greater than PMP be charged and recorded in SWBT's regulated accounts when a substantial third-party market exists. The audit team estimates the effect of this misinterpretation of the affiliate transactions rules to be higher rent charges to SWBT of approximately \$92,000 for the period 1989 - 1992.

(b). The cost of unoccupied rooms at the Hotel Majestic are charged to SWBT. SBC, the parent company, has an agreement with the Hotel Majestic, in which AMI has an ownership interest, whereby 40 rooms are reserved for 4 days a week for 42 weeks and an additional 10 rooms are reserved for 365 days for SBC's employees and guests at \$80 per day per room. In accordance with the terms of this agreement, SBC agrees to pay the charges for unoccupied reserved rooms. Instead, the Hotel Majestic bills SWBT monthly for unoccupied reserved rooms. These charges are then recorded by SWBT in Account 6720 General and Administrative. The audit team concludes that a portion of these charges could have been allocated by SBC to SWBT, but could not determine with specificity how much, because the Hotel Majestic was not able to provide information regarding the number of rooms rented by affiliates and SWBT. Overall, the audit team

determined that approximately \$776,000 in unoccupied room charges were billed to SWBT during the period 1989 - 1992.

(c). The cost of room rate differentials at the Hotel Majestic were charged to SWBT. When an SBC guest, who can be an employee of any affiliate of SBC, made the hotel reservations through Travel Services, which is a division of SWBT, the Hotel charged the SBC guest \$65 for weekdays and \$49 per day on weekends. The difference between the contract rate of \$80 and the amount paid was charged to Travel Services and booked in the regulated General and Administrative account. During the period 1989 - 1992, the audit team determined that approximately \$261,000 of these room rate differentials were charged to SWBT. However, these rate differential billings were discontinued in September 1993 during the audit team's review. The audit team could not determine with certainty how much of the above amount would have been appropriately charged to SWBT because, again, the records maintained by the Hotel Majestic did not provide for summaries of amounts charged to each affiliate.

(d). The weekend room rate charged at the Hotel Majestic is higher than prevailing market price (PMP). The prevailing weekend rate per room charged by the Hotel Majestic is \$49 per day. The rate charged for the 10 rooms which are also reserved for the weekend is \$80 per day. This practice is contrary to the affiliate transactions rules which require that SWBT record charges in its regulated accounts at no greater than PMP when a substantial third-party market exists. The maximum potential effect of SWBT recording charges in its regulated accounts in excess of PMP for weekend rates during 1989 - 1992 is approximately \$130,000.

8. In the course of this audit, the audit team noted another item unrelated to compliance with the affiliate transactions standards. During the later part of 1992 and early 1993, SBC corporate headquarters were relocated from St. Louis, Missouri to San Antonio, Texas. SBC booked a substantial accrual expense to cover the cost of this move, of which more than 50% was charged to SWBT and recorded by SWBT in its books of record. The reason given for this move was that SBC wanted to be closer to its growth market. As an example, Southwestern Bell Mobile Systems, Inc. (SBMS), the cellular communications company with headquarters in Dallas, Texas, is one of the fastest-growing subsidiaries of SBC. Also, Telefonos de Mexico (Telcel), in which SBC, together with two other partners, holds a controlling interest, is one of the world's fastest-growing telephone companies. Finally, the Texas telephone operations account for 60% of SWBT's business. The audit team deems that SBC has not provided adequate justification for these costs to be allowable and recoverable from the telephone ratepayers. Therefore, each jurisdiction may want to give further consideration to this matter.

9. The audit team also reviewed the allocations of costs by Southwestern Bell Technology Resources, Inc. (TRR) and the pricing of products sold and services rendered to SWBT by two other affiliates: Southwestern Bell Telecommunications, Inc. (Telecom),

and Southwestern Bell Mobile Systems, Inc. (SBMS). TRI provides, primarily, applications research to SWBT. During the period under review, substantially more than 50% of its total costs were billed to SWBT. Telecom sells telephone sets, data communications equipment, and related installation, repair and maintenance services to SWBT. During the period under review, a small amount of its total sales were to SWBT. SBMS sells cellular telephone service and products to SWBT. During the period under review, a very small amount of total SBMS revenue represented billings to SWBT. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that the allocation of costs or the pricing and recording of the transactions charged by all three affiliates were not in compliance with the applicable affiliate transactions standards. Furthermore, nothing came to the attention of the audit team that would indicate that the telephone ratepayers have been adversely affected by transactions between these three affiliates and SWBT for noncompliance with these standards.

10. Overall, during the period 1989 - 1992, approximately \$880 million were billed by affiliates, excluding Bellcore, to SWBT. The majority of these billings came from SBC, Southwestern Bell Yellow Pages, Inc., and TRI. The affiliates selected for testing accounted for approximately 70% of total billings to SWBT in 1992. The audit team considered, but did not select for audit, the transactions with the yellow pages operations, because these transactions have been, are, or will be audited separately by the five state jurisdictions.

11. In addition, the audit team reviewed the pricing of the services rendered by SWBT to its affiliates. Excluding tariffed services and the services rendered to Bellcore, SWBT billed approximately \$129 million to its affiliates during the period under review. These services were primarily of an administrative nature. The audit team selected and tested the pricing of seven services which, together with the review of asset transfers, represented approximately 65% of the total amount billed to affiliates in 1992. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that SWBT services provided to affiliates and assets transferred 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 have been adversely affected by transactions between SWBT and affiliates for noncompliance with these standards.

12. In the selection of areas for audit, the audit team was careful as to not cause audit duplication and to employ its resources in the most efficient manner. The audit team excluded from the audit universe transactions with Bell Communications Research, Inc. (Bellcore). Bellcore is the central research organization of the seven regional Bell operating companies (RBOCs). SWBT owns one-seventh (1/7) of Bellcore. The audit team did not consider for audit the services rendered by Bellcore to SWBT, because these transactions were previously audited by a separate joint audit team. As a result of that audit, two reports were issued, one in October 1991 and the other in November 1992.

Services rendered by SWBT to Bellcore during the period 1989 - 1992 were \$62 million. The audit team also excluded these costs from its audit universe. The team saw minimal risk for subsidies as more than six-sevenths (6/7) of these costs would be recovered from the other regional telephone companies, which are not affiliated with SWBT. Therefore, the audit team viewed these transactions as having occurred at arm's length. Finally, the audit team excluded from its review tariffed services rendered by SWBT to affiliates, because SWBT treated affiliates no different than any other customer. Therefore, the audit team saw minimal opportunity for cross-subsidy to exist in this area.

SOUTHWESTERN BELL TELEPHONE COMPANY'S ANALYSIS

Executive Summary

SWBT believes that its affiliate transactions are in full compliance with the FCC's affiliate transaction rules and notes that the Audit Report, for the most part, supports this belief. The audit team, after conducting an initial survey audit of all SWBT affiliate transactions, focused on six specific areas of transactions. The criteria used in selecting the six areas were materiality (large dollar amounts) and areas where the potential for cross subsidies exist. The audit team notes that the six areas selected for the more focused audit enabled 100% of the services rendered by SWBT to affiliates and approximately 70% of the services rendered by affiliates to SWBT to be examined by the joint audit team.

In four of the six areas chosen the audit team found there was nothing to indicate that the transactions were not accounted for in a manner consistent with the applicable FCC affiliate transaction standards. SWBT views this language as positive and accurate.

The audit team however concluded that certain allocations from SBC to SWBT and certain transactions with AMI were, in their opinion, inconsistent with the FCC's affiliate transaction rules.

In several areas the audit team's adverse conclusions are incorrect. The audit team has not reasonably interpreted the FCC rules or fairly examined the issues. For example, the audit team:

- A. **Changed the Stated Audit Standard Without Notice in Order to Arrive at an Adverse Finding** - The stated audit scope was compliance with the FCC affiliate transaction rules. However, the audit team criticizes the relocation of SBC's corporate headquarters, based not on any failure to comply with the affiliate transaction rules, but rather on an alleged failure to meet a prudence of expense standard. The audit team states it seems that SBC has failed to provide "adequate justification for these costs to be allowable and recoverable from the telephone ratepayers". SWBT was not aware that it was expected to meet a retreating standard until it received the Audit Report. The audit team does not have an adequate basis to make such a finding.
- B. **Ignored Relevant Information in Making Adverse Findings** - In an attempt to legitimize a finding of no supporting time reporting documentation, the audit team ignores a wealth of information and documentation provided regarding time reporting, including information provided through personal interviews with 43 employees.

The audit team claims that the lack of survey time studies at SBC hindered their ability to verify SBC time reporting. SWBT notes that the survey time studies are an insignificant element of SBC time reporting, and used

for the sole purpose of evaluating positions whose responsibilities have changed. More integral to the entire time reporting system are the FASC Information Cards which each employee signs each year verifying their time charges. Once this happens, prior time records are inconsequential.

An inordinate amount of information was provided to the audit team to verify time charges at SBC - payroll records, job descriptions, charging directions, interviews with 43 employees, etc.. The audit team surprisingly ignores all of this relevant information and mistakenly argues that the survey time study was the hinge-pin of the entire system. This is not correct or reasonable.

- C. Reaches Erroneous Results - The audit team reaches a result whereby SWRT, the largest SBC subsidiary, would receive a zero cost allocation from the parent for image advertising which clearly benefits SWRT. The audit team also adjusted the SBC general allocator to include retained expenses that are not assigned or allocated. The effect is to substantially distort SWRT's fair share of, and primary role in, continuing the need for such costs. SWRT maintains that the audit team has misapplied the affiliate transactions rules, resulting in an allocation that could not stand a test of reasonableness.

In an effort to verify lease charges to SWRT from AMI, the audit team averaged the lease payments of non-affiliates. SWRT was not aware this was an acceptable methodology for determining prevailing price.

- D. Miscalculation and Questionable Computations - The computations of the effects of the findings are flawed. For example, the audit team determined that its finding regarding the general allocator was worth a total reduction in the allocation to SWRT of \$62.5 million over four years. SWRT's computation, based on the audit team's philosophy, resulted in a reduction of that allocation to only \$37.6 million. Finally, the audit team calculated the amount over a four-year period. Though this resulted in a large number, it is more common to determine the financial impact of an issue over one year. Even based on their erroneous computation, the 1993 amount is only \$23.2 million.

SWRT emphasizes that it does view the audit report as largely positive, and that the audit report confirms that SWRT is, for the most part, in compliance with the FSC's affiliate transaction rules. However, SWRT takes strong exception to those areas where the audit team has claimed we are not in compliance with the rules. We submit the following in critique of the audit report.

JOINT AUDIT TEAM'S REPLY COMMENTS

The audit team has reviewed SWBT's comments and continues to fully support its findings and conclusions contained in the joint audit report on its review of affiliate transactions at SWBT. The audit team believes that it was fair and objective in reaching its conclusions. This is evident by the facts presented in the joint audit report, which clearly demonstrate when the affiliate transactions with SWBT were in compliance with the affiliate transactions standards and when they were not. Based on the conduct of this audit, there is no indication that the concerns initially expressed about joint audits by SWBT have materialized. Therefore, future joint audits should be encouraged.

SWBT claims that in several areas, the audit team's adverse conclusions are incorrect and that the audit team has unreasonably interpreted the FCC rules or unfairly examined the issues. The audit team takes exception to all SWBT allegations; specifically, those allegations addressed herein. Silence regarding any SWBT assertion should not be construed as acceptance.

A. The Audit Team Did not Change the Stated Audit Standard Without Notice in Order to Arrive at an Adverse Finding as Charged by SWBT

The scope of this audit, agreed to by both SWBT and the audit team, clearly allows for audit effort that goes further than the six stated areas reviewed by the joint audit team. Regardless of this fact, the charge to SWBT by SBC for relocating SBC's corporate offices from St. Louis, Missouri to San Antonio, Texas is clearly an affiliate transaction. The audit team was neither critical nor treated this charge as a finding, contrary to SWBT's comments on this issue. The audit team merely presented the facts as the audit team sees them. To imply that this work was done merely to generate an adverse finding is both incorrect and totally unsupported by the facts.

B. The Audit Team Did Not Ignore Relevant Information in Making Adverse Findings

SWBT claims the audit team ignored a wealth of information and documentation regarding time reporting at SBC. The audit team considered and examined all documentation provided by the company. It even employed alternative audit procedures in order to determine whether the computation of the cost allocators derived from time reporting could somehow be verified. The company could not produce either the time studies used for the computation of these cost allocators or any sort of contemporaneous time record. According to the company, the audit team had to merely accept the employees' verbal statements that the time allocators were correct without any sort of

corroborative evidence. SWBT knows, or should know, the type of evidence that the auditors were seeking, but it did not provide such documentation.

SWBT notes "that the survey time studies are an insignificant element of SBC time reporting, and used for the sole purpose of evaluating positions whose responsibilities have changed." The audit team strongly disagrees with this statement and believes that time reporting is a significant element for allocating SBC's costs to its subsidiaries. SBC performs labor intensive functions which could only be allocated by accurate time reporting. The absence of support for accurate time reporting could put in question all costs allocated by SBC. The audit team finds SWBT's position contradictory to SBC's newly revised CAS Users' Guide wherein SBC establishes the following requirement: "Each employee will be required to provide the support used in determining their Cost Center Number (CCN) assignments and percentages. Managers may want to consider conducting annual time studies which would be a strong means of support for CCN assignments." This revision supports the audit team's conclusion.

C. The Audit Team Did Not Reach Erroneous Results

SWBT implies that, because it is the largest subsidiary of SBC, it must benefit from image advertising, presumably, in direct proportion to its relative size. The audit team was not provided with documentation to support such claim. Furthermore, the audit team strongly disagrees that image advertising benefits primarily the telephone company. On the contrary, the audit team believes that SWBT affiliates would be the primary beneficiaries of image advertising by association with SWBT, a company which has an established reputation and which has been in existence for a long time.

The audit team questioned the formula used to allocate SBC's marketing costs since it is based on a combination of SBC directly incurred marketing costs and subsidiary directly incurred marketing costs. This practice is clearly not in conformance with the affiliate transactions costing standards, which provide that only the allocating company's incurred costs be included in the formula. This SBC self-designed formula effects a disproportionate assignment of marketing costs to SWBT. Contrary to SWBT's position, the audit team believes that SWBT has misapplied the affiliate transactions rules.

The audit team disagrees with SWBT's assertion that the costs retained by SBC should be excluded from the calculation of the general allocator. The audit team's conclusion on this issue is based upon an appropriate identification of the beneficiaries of SBC's services. It is indisputable that the benefits of certain SBC activities do not accrue to any subsidiaries, including SWBT. These activities would include, among other things, costs associated with merger and acquisition opportunities and new venture start-ups. SBC appropriately retains these costs, since these services are of benefit to its

stockholders. In effect, SBC is direct charging such costs to itself. Therefore, these SBC direct charges should be treated no differently than direct charges to SWBT or any other subsidiary for purposes of allocating residual costs. The audit team stands firm on this issue and inclusion of these costs in the computation of the general allocator is appropriate.

In reference to the issues related to transactions with AMI, SWBT is apparently in agreement with the audit team's findings on the inappropriate practice of charging room rate differentials at the Hotel Majestic to SWBT, since it discontinued this practice in September of 1993, after the audit team brought this matter to the attention of the company. However, the audit team is concerned that the Home Relocation Services Agreement does not require authorization by SWBT's officials, since SBC authorized this contract. The audit team considers this a serious matter having the potential of committing SWBT to contractual agreements with any of its affiliates, without SWBT's authorization. Finally, SWBT confuses the facts when it addresses the development of the general allocator at AMI, instead of addressing the apportioning of rate base items to separate lines of business.

D. The Audit Team Did Not Miscalculate and Overstate Computations

The audit team's computations of the effects of the findings are not flawed. In disagreeing with the audit team's calculated amounts for the general allocator, SWBT confuses rather than clarifies the situation. The audit report, for example, shows the calculation both by year and in total for the four year period. The audit team considers this presentation neither unusual nor erroneous. The total amount shown in the audit report is \$62.2 million, rather than the \$62.5 million in SWBT's comments.

SWBT claims that "[e]ven based on their erroneous computation, the 1992 amount is only \$22.2 million." Since the audit report clearly shows the 1992 amount to be \$13.0 million, the audit team is not aware of the source of SWBT's \$22.2 million. SWBT apparently calculated the 1992 amount differently than the audit team and then attributed this different calculation to the audit team. The audit team's computation results in \$13.0 million as shown in the report and not \$22.2 million as SWBT suggests.

SWBT's computation, "based on the audit team's philosophy, resulted in a reduction of that allocation to only \$37.6 million." SWBT has understated the four year total by a factor nearly as high as its overstatement of the 1992 amount, discussed above. Finally, the audit team's computations were based on company supplied data.

Acknowledgements

Concerns over potential cross-subsidies between the telephone companies and the nonregulated affiliates of the Regional Bell Operating Companies (RBOCs) prompted the National Association of Regulatory Utility Commissioners (NARUC) to pass a resolution on November 13, 1991 to conduct audits of affiliate interests at all the RBOCs. These audits were to be conducted by joint audit teams comprised of staff from the various state regulatory commissions as well as the Federal Communications Commission (FCC). This resolution entrusted the implementation of these joint audits to the NARUC Staff Subcommittee on Accounts.

The joint audit team that examined the affiliate transactions at Southwestern Bell Telephone Company (SWBT) was comprised of the following members:

Rudolph Bruno, Joint Audit Manager - Federal Communications Commission
Joseph Paretti - Federal Communications Commission
Russell Widmer - Arkansas Public Service Commission
Ann Diggs - Kansas Corporation Commission
Chris Barron - Kansas Corporation Commission
Peter Goss - Missouri Public Service Commission
Michele Krug - Oklahoma Corporation Commission
Ed Farrar - Oklahoma Corporation Commission
Blake Herndon - Texas Public Utility Commission

Coordination of a project of the magnitude of this joint audit of SWBT's affiliate transactions would not have been possible if not for the efforts of numerous individuals. At this juncture, the joint audit team would like to recognize and express appreciation to those individuals who helped make this project a success.

First, we wish to express thanks to the State Commissioners Oversight Committee comprised of the following individuals without whose guidance and perseverance this joint audit would not have been possible:

Chairman Sam I. Esten, Jr. - Arkansas Public Service Commission
Commissioner F.S. Jack Alexander - Kansas Corporation Commission
Commissioner Kenneth McClure - Missouri Public Service Commission
Chairman J.C. Watts, Jr. - Oklahoma Corporation Commission
Chairman Robert W. Goe - Texas Public Utility Commission

We also wish to thank the following State Commission and FCC staff directors who were instrumental in allocating their limited resources to provide audit personnel for this joint audit:

**Jerrell Clark - Arkansas Public Service Commission
Don Low - Kansas Corporation Commission
David Rauch - Missouri Public Service Commission
Ernest Johnson - Oklahoma Corporation Commission
Rowland Curry - Texas Public Utility Commission
Jose-Luis Rodriguez - Federal Communications Commission**

We express our gratitude to all the attorneys from the State Commissions, as well as the FCC, who labored long and hard to arrive at a protective agreement with SWBT and for their assistance through the entire joint audit process. A special thank you is extended to Steven Dottheim, Deputy General Counsel - Missouri Public Service Commission, for his tireless efforts on behalf of the joint audit process and the entire audit team. Steven has been very supportive of this joint audit and was always ready to help no matter what the calling.

To the staff of Southwestern Bell Corporation and its affiliates we express our thanks for their efforts. We extend a special thank you to Karol Sweltzer of Southwestern Bell Corporation - Washington, Inc. for her diligent efforts in providing information and for coordinating activities between the audit team and the Southwestern Bell staff.

Finally, we express our most sincere gratitude to Gordon Persinger, Director of Policy and Planning Division of the Missouri Public Service Commission and member of the NARUC Communications Subcommittee and the NARUC Oversight Committee. Without Gordon's leadership and determination this joint audit would not have been possible.

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**JOINT AUDIT REPORT
ON
REVIEW OF AFFILIATE TRANSACTIONS
AT
SOUTHWESTERN BELL TELEPHONE COMPANY**

I. EXECUTIVE SUMMARY

1. This report is the product of a joint audit team comprised of auditors from the regulatory commissions of the states of Arkansas, Kansas, Missouri, Oklahoma, and Texas and auditors from the Federal Communications Commission (FCC). It covers the results of the examination of affiliate transactions at Southwestern Bell Telephone Company (SWBT). SWBT is the telephone subsidiary of Southwestern Bell Corporation (SBC), one of the seven regional telephone holding companies created at the divestiture of AT&T on January 1, 1984. SBC is headquartered in San Antonio, Texas and as of December 31, 1992 employed approximately 60,000 people, had more than \$10 billion in operating revenues, and approximately \$24 billion in assets. SBC provides telephone service, sales of customer premises equipment, yellow page advertising, printing and distribution of telephone directories, wireless communications services, and has investments in several international operations, through many subsidiary companies. Affiliate transactions cover the provision of services and sales of assets between and among sister companies of an affiliated group such as SBC.

2. The objective of this examination of affiliate transactions was, (i) to determine compliance with the affiliate transactions standards and, (ii) to ensure that the telephone ratepayers had not been adversely affected by potential cross-subsidies flowing to nonregulated affiliates as a result of noncompliance with these standards. Cross-subsidies could flow to the nonregulated affiliates in the form of overcharges to the telephone company. Conversely, cross-subsidies could flow to the nonregulated affiliates in the form of undercharges by the telephone company. The FCC recognized that transactions with affiliates may not be conducted at arm's length, therefore, it instituted accounting safeguards (costing standards) to protect the telephone ratepayers. These accounting safeguards were established in CC Docket 88-111, Report and Order, released February 6, 1987, and are contained in the Uniform System of Accounts (USOA) Section 32.27 Transactions with Affiliates and Section 64.901 Allocation of Costs. The audit team employed these accounting safeguards to determine compliance and to gauge the effect of any transgression on the telephone ratepayers. The examination covered the period 1989 - 1992 and included reviews of policies and procedures and tests of selected transactions with particular emphasis on 1992 activities.

3. For the purpose of this audit, the FCC's affiliate transactions standards have been utilized by the auditors of the regulatory agencies of the five states having jurisdiction over SWBT. However, other regulations, statutes, and/or ratemaking standards in each of the jurisdictions may impact the determination of the extent to which affiliate transactions

will be considered just and reasonable for state ratemaking purposes. The audit team did not review the affiliate transactions for compliance with other applicable standards, if any, and expresses no opinion on compliance with such standards.

4. From the audit work performed, the audit team concludes that the affiliates' dealings with SWBT are not in full compliance with the affiliate transactions standards and, depending on SWBT's earnings and the regulatory process in each regulatory jurisdiction, the telephone ratepayers may have been burdened by a potential \$93.7 million in excess costs resulting from transactions with two of its affiliates: Southwestern Bell Corporation (SBC), the parent company, and Southwestern Bell Asset Management, Inc. (AMI), the real estate affiliate. In addition, the dollar impact resulting from the lack of support for time reporting by SBC cannot be determined. Because of differences in the regulatory process in each jurisdiction, the audit team has chosen not to make any recommendations in this report. Each jurisdiction may take steps as deemed appropriate.

5. The opinions and conclusions stated in this report are those of the audit team and not necessarily those of the individual regulatory commissions participating in this audit. This report has not been presented to the individual regulatory commissions for approval as to the accuracy of the statements contained herein. Authorization to publish this report does not constitute an express or implied decision by the individual regulatory commissions on any of the issues raised by this report.

6. The audit team's conclusions related to SBC, totaling \$92.4 million, include:

(a). No supporting documentation for time charging by SBC's employees. For the most part, the cost allocation system used by SBC to either directly assign or allocate its costs to its subsidiaries is driven by survey time studies. The audit team was not provided and could not review the adequacy of the results of the survey time studies for the audit period 1989 - 1992. Consequently, the audit team could not determine the reasonableness of SBC's expenses charged to SWBT. The audit team was told by a representative of SBC that at one time four-week survey time studies were made, but that none are currently available. Section 32.12(b) of the Uniform System of Accounts for Telecommunications Companies requires, in part, that "...[t]he detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission".

(b). Improper marketing allocator. SBC allocates its indirect marketing costs (those costs that cannot be directly assigned to a subsidiary) by the use of a marketing allocator derived from the sum of SBC's directly-assigned marketing costs to its subsidiaries as well as the direct marketing costs incurred by those subsidiaries. This practice is not in conformance with the regulatory standards and procedures for the apportionment of joint and common costs which require, "...all costs that can be apportioned on the basis of direct assignment or cost causal attribution measures to be so apportioned. Residual marketing expenses will be divided between regulated and nonregulated activities based on the ratio of the directly assigned and attributable costs".

CC Docket 86-111, Report and Order, at paragraph 190. The audit team interprets this rule to mean that only the costs directly assigned and attributed, if any, to the various subsidiaries by the apportioning company should be included in the computation of the marketing allocator. The effect of SBC's misinterpretation of the rule was an additional allocation of \$30.2 million of marketing expenses to SWBT for the years 1989 - 1992. These expenses were then recorded in SWBT's books of record.

(c). Improper general allocator. In the development of the general allocator, SBC excludes the costs that it directly assigns to the stockholders. The audit team believes that this practice is contrary to regulatory costing standards (Section 64.901 Allocation of Costs), which require that the general allocator be computed by using the ratio of all expenses directly assigned or attributed to activities or subsidiaries, including costs assigned to the stockholders. The exclusion of the costs apportioned to the stockholders from the computation of the general allocator generated an additional \$62.2 million of costs allocated to SWBT for the years 1989 - 1992. These costs were then recorded in SWBT's books of record.

7. The audit team's conclusions related to AMI, totaling \$1.3 million, include:

(a). Office space leased to SWBT at more than prevailing market price. For the period 1989 - 1992, AMI leased office space to SWBT at three locations. At two of these locations, Pinehollow in Houston, Texas and Centerpoint in Arlington, Texas, AMI rented office space to SWBT at fully distributed cost (FDC) when a prevailing market price (PMP) rate had been established. At these two buildings, more than 40% of the total space was rented to nonaffiliated third parties at an average price per square foot lower than that charged to SWBT. This practice is contrary to the affiliate transactions rules which require that rates no greater than PMP be charged and recorded in SWBT's regulated accounts when a substantial third-party market exists. The audit team estimates the effect of this misinterpretation of the affiliate transactions rules to be higher rent charges to SWBT of approximately \$92,000 for the period 1989 - 1992.

(b). The cost of unoccupied rooms at the Hotel Majestic are charged to SWBT. SBC, the parent company, has an agreement with the Hotel Majestic, in which AMI has an ownership interest, whereby 40 rooms are reserved for 4 days a week for 42 weeks and an additional 10 rooms are reserved for 365 days for SBC's employees and guests at \$80 per day per room. In accordance with the terms of this agreement, SBC agrees to pay the charges for unoccupied reserved rooms. Instead, the Hotel Majestic bills SWBT monthly for unoccupied reserved rooms. These charges are then recorded by SWBT in Account 6720 General and Administrative. The audit team concludes that a portion of these charges could have been allocated by SBC to SWBT, but could not determine with specificity how much, because the Hotel Majestic was not able to provide information regarding the number of rooms rented by affiliates and SWBT. Overall, the audit team determined that approximately \$776,000 in unoccupied room charges were billed to SWBT during the period 1989 - 1992.

(c). The cost of room rate differentials at the Hotel Majestic were charged to SWBT. When an SBC guest, who can be an employee of any affiliate of SBC, made the hotel reservations through Travel Services, which is a division of SWBT, the Hotel charged the SBC guest \$65 for weekdays and \$49 per day on weekends. The difference between the contract rate of \$80 and the amount paid was charged to Travel Services and booked in the regulated General and Administrative account. During the period 1989 - 1992, the audit team determined that approximately \$261,000 of these room rate differentials were charged to SWBT. However, these rate differential billings were discontinued in September 1993 during the audit team's review. The audit team could not determine with certainty how much of the above amount would have been appropriately charged to SWBT because, again, the records maintained by the Hotel Majestic did not provide for summaries of amounts charged to each affiliate.

(d). The weekend room rate charged at the Hotel Majestic is higher than prevailing market price (PMP). The prevailing weekend rate per room charged by the Hotel Majestic is \$49 per day. The rate charged for the 10 rooms which are also reserved for the weekend is \$80 per day. This practice is contrary to the affiliate transactions rules which require that SWBT record charges in its regulated accounts at no greater than PMP when a substantial third-party market exists. The maximum potential effect of SWBT recording charges in its regulated accounts in excess of PMP for weekend rates during 1989 - 1992 is approximately \$130,000.

8. In the course of this audit, the audit team noted another item unrelated to compliance with the affiliate transactions standards. During the later part of 1992 and early 1993, SBC corporate headquarters were relocated from St. Louis, Missouri to San Antonio, Texas. SBC booked a substantial accrual expense to cover the cost of this move, of which more than 50% was charged to SWBT and recorded by SWBT in its books of record. The reason given for this move was that SBC wanted to be closer to its growth market. As an example, Southwestern Bell Mobile Systems, Inc. (SBMS), the cellular communications company with headquarters in Dallas, Texas, is one of the fastest-growing subsidiaries of SBC. Also, Telefonos de Mexico (Telmax), in which SBC, together with two other partners, holds a controlling interest, is one of the world's fastest-growing telephone companies. Finally, the Texas telephone operations account for 60% of SWBT's business. The audit team deems that SBC has not provided adequate justification for these costs to be allowable and recoverable from the telephone ratepayers. Therefore, each jurisdiction may want to give further consideration to this matter.

9. The audit team also reviewed the allocations of costs by Southwestern Bell Technology Resources, Inc. (TRI) and the pricing of products sold and services rendered to SWBT by two other affiliates: Southwestern Bell Telecommunications, Inc. (Telecom), and Southwestern Bell Mobile Systems, Inc. (SBMS). TRI provides, primarily, applications research to SWBT. During the period under review, substantially more than 50% of its total costs were billed to SWBT. Telecom sells telephone sets, data communications equipment, and related installation, repair and maintenance services to SWBT. During the period under review, a small amount of its total sales were to SWBT. SBMS sells cellular

telephone service and products to SWBT. During the period under review, a very small amount of total SBMS revenue represented billings to SWBT. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that the allocation of costs or the pricing and recording of the transactions charged by all three affiliates were not in compliance with the applicable affiliate transactions standards. Furthermore, nothing came to the attention of the audit team that would indicate that the telephone ratepayers have been adversely affected by transactions between these three affiliates and SWBT for noncompliance with these standards.

10. Overall, during the period 1989 - 1992, approximately \$880 million were billed by affiliates, excluding Bellcore, to SWBT. The majority of these billings came from SBC, Southwestern Bell Yellow Pages, Inc., and TRI. The affiliates selected for testing accounted for approximately 70% of total billings to SWBT in 1992. The audit team considered, but did not select for audit, the transactions with the yellow pages operations, because these transactions have been, are, or will be audited separately by the five state jurisdictions.

11. In addition, the audit team reviewed the pricing of the services rendered by SWBT to its affiliates. Excluding tariffed services and the services rendered to Bellcore, SWBT billed approximately \$129 million to its affiliates during the period under review. These services were primarily of an administrative nature. The audit team selected and tested the pricing of seven services which, together with the review of asset transfers, represented approximately 65% of the total amount billed to affiliates in 1992. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that SWBT services provided to affiliates and assets transferred 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 have been adversely affected by transactions between SWBT and affiliates for noncompliance with these standards.

12. In the selection of areas for audit, the audit team was careful as to not cause audit duplication and to employ its resources in the most efficient manner. The audit team excluded from the audit universe transactions with Bell Communications Research, Inc. (Bellcore). Bellcore is the central research organization of the seven regional Bell operating companies (RBOCs). SWBT owns one-seventh (1/7) of Bellcore. The audit team did not consider for audit the services rendered by Bellcore to SWBT, because these transactions were previously audited by a separate joint audit team. As a result of that audit, two reports were issued, one in October 1991 and the other in November 1992. Services rendered by SWBT to Bellcore during the period 1989 - 1992 were \$62 million. The audit team also excluded these costs from its audit universe. The team saw minimal risk for subsidies as more than six-sevenths (6/7) of these costs would be recovered from the other regional telephone companies, which are not affiliated with SWBT. Therefore, the audit team viewed these transactions as having occurred at arm's length. Finally, the audit team excluded from its review tariffed services rendered by SWBT to affiliates, because SWBT treated affiliates no different than any other customer. Therefore, the audit

team saw minimal opportunity for cross-subsidy to exist in this area.

II. INTRODUCTION

13. Southwestern Bell Corporation (SBC) is one of the seven regional telephone holding companies created at the divestiture of AT&T on January 1, 1984. SBC is headquartered in San Antonio, Texas and as of December 31, 1992 employed approximately 60,000 people, had more than \$10 billion in operating revenues, and approximately \$24 billion in assets. SBC's main lines of business are: Network Services and Equipment, Advertising and Publishing, International Operations, Wireless Communications, and Support Services.

14. Network Services and Equipment is comprised primarily by Southwestern Bell Telephone Company (SWBT), the largest subsidiary, and Southwestern Bell Telecommunications, Inc. (Telecom). SWBT provides telephone service in the states of Arkansas, Kansas, Missouri, Oklahoma, and Texas. Telecom provides complex digital PBX systems and data communications systems to businesses operating within the five states indicated above and consumer telephones throughout the United States and in 39 foreign countries. Other subsidiaries included in this line of business provide voice messaging services.

15. Advertising and Publishing is comprised primarily by Southwestern Bell Yellow Pages, Inc., Southwestern Bell Printing Company, and Southwestern Bell Publications, Inc. Through these subsidiaries, SBC sells yellow pages advertisements. It also publishes and prints yellow and white page directories for SWBT as well as 269 directories for GTE. In February 1993, the commercial printing division of Southwestern Bell Printing Company was sold.

16. International Operations consists of Southwestern Bell International Holdings Corporation (SBIH). Through this subsidiary, SBC owns cable companies in the United Kingdom, where it provides both cable TV and telephone service, and interests in cable TV and directories in Israel and Australia. SBIH and two other partners, Grupo Carso and France Telecom, have a controlling interest in Telefonos de Mexico (Telmex), one of the world's fastest-growing telephone companies.

17. Wireless Communications is comprised of Southwestern Bell Mobile Systems, Inc. (SBMS), Southwestern Bell Personal Communications, Inc. (SBPC), and Metromedia Paging Services which was sold in mid-1993. These subsidiaries provide cellular telephone service and are experimenting with a new technology, personal communications services, and pocket phones in Houston, Texas.

18. Support Services is comprised of many companies that provide, primarily, support services to all the subsidiaries of SBC. In addition to SBC, the parent, the principal subsidiaries within this group are Southwestern Bell Technology Resources, Inc. (TRR) and Southwestern Bell Asset Management, Inc. (AMR). TRR provides applications research,

while AMI provides real estate services and maintains a portfolio of real estate investments.

19. SBC and the other regional telephone holding companies are very dynamic companies and look to acquire businesses which are best suited for their industry. Recently, some of them have either invested in or have made announcements for outright merger with companies in cable TV and entertainment industries. In February 1993, SBC announced the purchase of two cable TV franchises from Hauser Communications in the Washington D.C.-Virginia area for \$650 million. SBC plans to provide both cable TV and telephone service through these two franchises. In December 1993, SBC announced a joint venture with Cox Cable Communications. Current rules forbid telephone companies from providing television programming in their telephone service territories, but these restrictions do not apply outside their service territories.

III. OVERALL OBJECTIVE

20. The audit team's objective was to review transactions between SWBT and its affiliates. Specifically, the audit team sought: (i) to determine compliance with the affiliate transactions standards; and, (ii) to ensure that the telephone ratepayers were not adversely affected by potential cross-subsidies flowing to affiliates as a result of noncompliance with these standards. Cross-subsidies could flow to the nonregulated affiliates in the form of overcharges to the telephone company. Conversely, cross-subsidies could flow to the nonregulated affiliates in the form of undercharges by the telephone company. The Federal Communications Commission (FCC) has instituted accounting safeguards to protect the telephone ratepayers. These accounting safeguards are explained below. The audit team focused primarily on 1992 activities. However, to the extent that there were any infractions of these standards, the audit team computed the potential effect of these infractions on the telephone ratepayers for the entire audit period 1989 - 1992. In addition, the audit team did not preclude the possible expansion of the scope of this audit resulting from information, related to affiliate transactions, which came to its attention during this audit.

IV. AFFILIATE TRANSACTIONS STANDARDS

21. The affiliate transactions standards used in this audit are contained in the Uniform System of Accounts (USOA) Section 32.27 Transactions with Affiliates and Section 64.901 Allocation of Costs. These accounting safeguards were established by the FCC in Docket 88-111 Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities.

22. For the purpose of this audit, the FCC's affiliate transactions standards have been utilized by the auditors of the regulatory agencies of the five states having jurisdiction over SWBT. However, other regulations, statutes, and/or rate-making standards in each

of the jurisdictions may impact the determination of the extent to which affiliate transactions will be considered just and reasonable for state ratemaking purposes. The audit team did not review the affiliate transactions for compliance with other applicable standards, if any, and expresses no opinion on compliance with such standards.

23. In accordance with these standards, assets sold by a regulated telephone company to an affiliate should be recorded in the regulated accounts at the tarified rate or prevailing market price (PMP) offered to the general public, as applicable. In the absence of a tarified rate or PMP, the revenue from the sale of assets should be recorded in the regulated accounts at the higher of fair market value or net book value.

24. Assets sold by an affiliate to a regulated telephone company should be recorded in the regulated accounts at the PMP offered to the general public, if available. In the absence of a tarified rate or PMP, the assets should be recorded in the regulated accounts at the lower of fair market value or cost less all valuation reserves.

25. Services sold by a regulated telephone company to an affiliate should be recorded in the regulated accounts at the tarified rate or PMP, if available. In the absence of a tarified rate or PMP, the revenue from the sale of the services should be recorded in the regulated accounts at fully distributed cost (FDC), which includes a return on investment (ROI) at the authorized interstate rate. This rate was 12% in 1989 and 1990, 11.25% in 1991 and 1992. The states adjust this rate to their authorized rate of return in their state ratemaking process.

26. Services sold by an affiliate to a regulated telephone company should be recorded in the regulated accounts at the market rate, if the same services are also substantially sold to the general public. In the absence of a market rate, the services should be recorded in the regulated accounts at FDC.

27. Fully distributed cost (FDC) should be determined as follows:

- a. Costs should be directly assigned whenever possible.
- b. All other costs are deemed to be common costs. There are three types of common costs:
 - Costs where the cost causer can be directly identified. These costs should be allocated on the basis of direct analysis.
 - Costs where direct analysis is not possible should be allocated on the basis of some indirect method of cost causation.
 - All other common costs should be allocated by using a general allocator computed by using the ratio of all costs directly assigned or allocated to two or more units.

28. Central office equipment (COE) and outside plant investments should be allocated between the regulated and nonregulated activities on the basis of peak nonregulated usage in any one calendar year of the three-year forecasted usage.

29. Based on these standards, the affiliates doing business with the telephone companies are indirectly regulated through the amounts which must be booked in the regulated accounts of the telephone companies. To the extent that the telephone companies book amounts which are different than as prescribed above, the possibility exists that the ratepayers have been burdened. Therefore, in an audit of affiliate transactions, one must first analyze the pricing practices and markets of the affiliate rendering the service and then one must review the accounting practices for recording these transactions at the telephone company.

V. COMPANIES EXAMINED

30. The following tables present the amounts billed by affiliates to SWBT and by SWBT to affiliates for the services rendered, products purchased, or assets sold during the period 1989 - 1992:

Amounts Billed by Affiliates to SWBT
(In millions)

	1989	1990	1991	1992
SBC (Parent Company)	\$146.9	\$114.5	\$102.3	\$119.6
SWB Yellow Pages, Inc.	35.4	55.6	63.3	62.5
Media, Inc.	18.5	0	0	0
SWB Technology Resources, Inc.	11.8	14.3	16.5	25.6
SWB Asset Management, Inc.	8.8	7.2	8.0	12.6
SWB Telecom, Inc.	6.0	7.5	10.3	11.3
SWB Mobile Systems, Inc.	1.4	2.0	2.2	2.2
SWB International Holdings Corp.	0	.1	0	4.5
Metromedia Paging Services, Inc.	.8	.9	.9	1.1
SWB Publications, Inc.	.8	1.1	.4	.3
SWB Printing Company	.5	1.0	.6	.4
SWB Enterprises, Inc.	0	0	0	.5
St. Louis Health Center	0	.1	0	0
Total	\$230.9	\$204.3	\$204.5	\$240.6

The total amounts billed by affiliates to SWBT for the years 1989 - 1992 was \$880.9 million.

**Amounts Billed by SWBT to Affiliates
(In millions)**

	1989	1990	1991	1992
SBC (Parent Company)	\$13.1	\$14.1	\$15.2	\$14.2
SWB Yellow Pages, Inc.	1.8	10.1	10.7	9.5
SWB Telecom, Inc.	.9	3.9	4.3	3.0
SWB Publications, Inc.	6.2	.5	.7	.5
SWB Technology Resources, Inc.	.2	.2	.1	6.5
SWB International Holdings Corp.	0	0	.8	.9
SWB Mobile Systems, Inc.	.5	.6	1.1	1.3
SWB Redevelopment Corporation	.2	.5	.6	.1
Metromedia Paging Services, Inc.	0	0	.3	.4
SWB Printing Company	0	0	0	.1
SWB Asset Management, Inc.	.1	.1	0	.1
SWB Int'l Development Corporation	0	.1	.3	0
SWB Enterprises, Inc.	0	0	0	2.1
Media, Inc.	2.7	0	0	0
Total	\$25.7	\$30.1	\$34.1	\$38.7

The total amounts billed by SWBT to affiliates for the years 1989 - 1992 was \$128.6 million.

31. For the purpose of presentation, the audit team has consolidated certain affiliate transactions shown above. All affiliate transactions to and from a subsidiary which was renamed or reorganized during the period under review are shown under the current name of the subsidiary. All affiliate transactions to and from subsidiaries under a Group Parent Company are shown under the name of that Group Parent Company. All affiliate transactions to and from service subsidiaries of the Parent Company (SBC), e.g., SWB Audit Services, SBC-Washington, Inc., have been grouped and shown under SBC. The dollar amounts shown in the preceding two tables may differ slightly from the dollar amounts shown in some sections of the report due to timing and accrual differences.

32. The audit team decided to audit the services rendered by SWBT to affiliates and the services rendered by the following affiliates to SWBT: Southwestern Bell Corporation (SBC), the parent company organization; Southwestern Bell Technology Resources, Inc. (TRI), the research subsidiary; Southwestern Bell Asset Management, Inc. (AMI), the real estate subsidiary; Southwestern Bell Telecommunications, Inc. (Telecom), the terminal equipment or customer premises equipment subsidiary; and, Southwestern Bell Mobile Systems, Inc. (SBMS), the cellular services company. By making this selection, 100% of the services rendered by SWBT to affiliates and approximately 70% of the services rendered by affiliates to SWBT were subject to examination by the joint audit team. The criteria employed by the team in making its selection was materiality (large dollar amounts) and areas where the potential for cross-subsidies might exist.

33. The audit team excluded from its review tariffed services rendered by SWBT to affiliates, because SWBT treated affiliates no different than any other customer. Therefore, the audit team saw minimal risk for cross-subsidy to exist in this area. Transactions with Bell Communications Research, Inc. (Bellcore) also were not considered for review by the audit team. Bellcore is the central research organization of the seven regional Bell telephone companies. SWBT owns one-seventh (1/7) of Bellcore. The services rendered by Bellcore to SWBT were previously audited by a separate joint audit team and the reports were issued in October 1991 and November 1992. Services rendered by SWBT to Bellcore during the period 1989 - 1992 amounted to \$62 million. The audit team also excluded these costs from its audit universe, since it saw minimal risk for subsidies as more than six-sevenths (6/7) of these costs would be recovered from the other regional telephone companies, which are not affiliated with SWBT. Therefore, the audit team viewed these transactions as having occurred at arm's length. Finally, the audit team considered, but did not select for audit, the yellow pages operations of SWBT which were, are, or will be audited by each of the five state jurisdictions.

34. Detailed accounts of the examination of the affiliate transactions selected for audit follow.

A. REVIEW OF ALLOCATIONS OF COSTS OF SOUTHWESTERN BELL CORPORATION TO SOUTHWESTERN BELL TELEPHONE COMPANY

Summary

35. The audit team has completed its review of the allocation of Southwestern Bell Corporation (SBC) parent organization costs to Southwestern Bell Telephone Company (SWBT). SBC was created at divestiture in 1984, currently employs approximately 500 people, and has its headquarters in San Antonio, Texas. During the audit period, 1989 - 1992, SBC recovered the bulk of its costs from eleven subsidiaries, with the major portion coming from SWBT.

36. The objective of this audit segment was to determine compliance with the affiliate transactions standards and to ensure that the telephone ratepayers had not been adversely affected by potential cross-subsidies which could flow to the nonregulated affiliates in the form of overcharges to some, undercharges to others, or misallocation of costs. The audit team's testing included a review of accounting records, company procedures and interviews of employees to determine that their time was being charged to the appropriate cost center. From the audit work performed, the audit team concludes that SBC's allocations of costs to SWBT are not in full compliance with the affiliate transactions standards and that depending on SWBT's earnings and the regulatory process in each regulatory jurisdiction, the potential exists that the ratepayers may have been burdened by \$92.4 million in excess cost allocations by SBC. In addition, the dollar impact resulting from the lack of support for time reporting cannot be determined. This conclusion is drawn from the facts below.

37. First, SBC has no supporting documentation for time charging by its employees. SBC's Cost Allocation System (CAS) is primarily driven by its employees' time charges which are based on four-week survey time studies. For the audit period 1989 - 1992, neither historical time studies nor any contemporaneous time records exist to support the accuracy of SBC's cost allocations to subsidiaries. Because of this lack of documentation, it is impossible to determine if SBC's charges to its subsidiaries are correct. This is not in compliance with both the rules, which require that detailed records be maintained [USOA Section 32.12(b)], and SBC's policy and procedures.

38. Second, SBC is using an improper marketing allocator. SBC allocates indirect marketing costs based on an allocator comprised of directly-charged marketing costs incurred by itself and directly-incurred marketing costs of each subsidiary. In 1992, there were no net direct-charged marketing costs to SWBT, yet SWBT was still allocated nearly 50% of the \$18.6 million of indirect marketing costs; a charge of approximately \$9.2 million. This practice is not in conformance with regulatory standards for the apportionment of joint and common costs which require "...all costs that can be apportioned on the basis of direct assignment or cost causal attribution measures to be so apportioned. Residual marketing expenses will be divided between regulated and nonregulated activities based on the ratio of the directly assigned and attributable costs." CC Docket 88-111, Report and Order, released February 6, 1987, at paragraph 190. The audit team interprets this rule to mean that only the costs directly assigned and attributable, if any, incurred by the apportioning company should be included in the computation of the marketing allocator. The effect of this misinterpretation of the rules by SBC is an additional allocation of \$30.2 million of marketing expenses to SWBT for the years 1989 - 1992. These expenses were then recorded in SWBT's books of record.

39. Third, SBC is using an improper general allocator. SBC allocates its costs using direct assignment, indirect attribution and the balance by means of a general allocator. The general allocator is based on the proportion of those costs already directly assigned or allocated and is applied to the residual costs. SBC retains (directly assigns to the stockholders) approximately 17% of its total incurred costs, yet it does not include

them in its calculation of the general allocator. As a result, the general allocator overassigned approximately \$62.2 million of SBC expenses to SWBT for the years 1989-1992. These costs were then recorded in SWBT's books of record. This practice is not in conformance with the rules, Section 64.901 Allocation of Costs.

40. In the course of this audit, the audit team noted another item unrelated to compliance with the affiliate transactions standards. In late 1992 and early 1993, SBC relocated its corporate headquarters from St. Louis, Missouri to San Antonio, Texas. A substantial expense accrual was booked in September 1992 to cover the anticipated cost of the move. SWBT was allocated more than 50% of that amount, which was recorded in SWBT's books of record. The reason given for this move was that SBC wanted to be closer to its growth markets. As an example, Southwestern Bell Mobile Systems, Inc., the cellular communications company, with headquarters in Dallas, Texas, is one of the fastest-growing subsidiaries of SBC. Also, Telefonos de Mexico (Telmex) in which SBC, together with two other partners, holds a controlling interest, is one of the worlds fastest-growing telephone companies. Finally, the Texas telephone operations account for 60% of SWBT's business. The audit team deems that SBC has not provided adequate justification for these costs to be allowable and recoverable from the telephone ratepayers. Therefore, each jurisdiction may want to give further consideration to this matter.

Background

41. The Southwestern Bell Corporation parent organization was created at divestiture in 1984 to provide strategic and financial management for both its existing and future subsidiaries. SBC also seeks new business opportunities and diversification of investments to safeguard the interests of the stockholders. The SBC parent company organization is headquartered in San Antonio, Texas and employs approximately 500 people. Prior to December 1992, SBC was located in St. Louis, Missouri.

42. During the audit period, 1989 - 1992, the main SBC operating subsidiaries consisted of the following eleven companies:

- Southwestern Bell Telephone Company (SWBT)**
- Southwestern Bell Yellow Pages, Inc. (SBYP)**
- Mast Advertising & Publishing, Inc.**
- Southwestern Bell Telecommunications, Inc. (Telecom)**
- Southwestern Bell Mobile Systems, Inc. (SBMS)**
- Metromedia Paging Services, Inc. (Metromedia)**
- Southwestern Bell Printing Company (SWBP) (formerly Gull Printing Company)**
- Southwestern Bell Publications, Inc. (SBP)**
- Southwestern Bell Asset Management, Inc. (AM)**
- Southwestern Bell International Holdings Corporation (SBH)**
- Southwestern Bell Enterprises, Inc. (SBE)**

43. Over the four year period 1989 - 1992, SBC recovered its costs from the above subsidiaries in the following amounts:

Amounts Billed by SBC to Subsidiaries
(In millions)

	1989	1990	1991	1992
Total SBC Costs	\$177.1	\$190.1	\$181.9	\$218.4
Billings to Subsidiaries:				
SWB Telephone Company *	115.4	113.8	102.1	118.5
SWB Yellow Pages, Inc. **	0	11.7	9.7	12.9
Mast Advertising & Publishing, Inc.**	0	2.2	2.3	3.0
SWB Telecom, Inc.	3.3	3.1	3.1	4.3
SWB Mobile Systems, Inc.	5.9	14.3	16.6	19.5
Metromedia Paging Services, Inc.	5.5	4.6	7.2	6.6
SWB Printing Company	1.2	1.2	1.5	2.1
SWB Publications, Inc.	12.0	0	0	0
SWB Asset Management, Inc.	.8	.8	1.1	1.2
SWB International Holdings Corp.	0	2.4	6.8	11.6
SWB Enterprise, Inc.	0	0	.1	.5
All Other Service Subsidiaries	1.4	1.9	1.6	1.7
Total Dollars Billed	\$145.5	\$155.4	\$152.1	\$181.9
Parent Retained Costs	31.6	34.7	29.8	36.5
Total Dollars Billed and Retained	\$177.1	\$190.1	\$181.9	\$218.4

* Amounts do not agree with SBC allocations on the schedule on page 10 of this report because that schedule includes reallocations from service subsidiaries, SWB Foundation costs, timing and accrual differences.

** Subsidiaries of SWB Publications, Inc. during 1989.

The percentage figures in the following table correspond to the dollar amounts in the preceding table:

Percent Billed by SBC to Subsidiaries
(Percent of Total)

<i>All Figures in this Table Are Percentage Amounts</i>	1989	1990	1991	1992
Subsidiary Billed:				
SWB Telephone Company	65.2	59.9	56.1	54.3
SWB Yellow Pages, Inc. *	.0	6.2	5.3	5.9
Mast Advertising & Publishing, Inc.*	.0	1.1	1.3	1.4
SWB Telecom, Inc.	1.9	1.6	1.7	2.0
SWB Mobile Systems, Inc.	3.3	7.5	9.1	8.9
Metromedia Paging Services, Inc.	3.1	2.4	4.0	3.0
SWB Printing Company	.7	.6	.8	1.0
SWB Publications, Inc.	6.8	.0	.0	.0
SWB Asset Management, Inc.	.4	.4	.6	.5
SWB International Holdings Corp.	.0	1.3	3.7	5.3
SWB Enterprise, Inc.	.0	.0	.1	.2
All Other Service Subsidiaries	.8	.7	.9	.8
Percentage - Total Dollars Billed	82.2	81.7	83.6	83.3
Percentage - Parent Retained Costs	17.8	18.3	16.4	16.7
Percentage - Total Costs	100%	100%	100%	100%

* Subsidiaries of SWB Publications, Inc. during 1989.

44. The focus of our audit was on SBC cost allocations and, particularly, those costs billed to the telephone company. Such costs represent the portion of SBC's charges which were funded by the ratepayers. Two trends are apparent from the above tables. First, the total costs incurred by SBC have not changed much over the four years, since,

for this comparison, 1992 should be reduced by the cost of relocating the parent organization from St. Louis to San Antonio. Second, SWBT's share of the total costs has been declining steadily. This decline in SWBT's share of total costs can, for the most part, be attributed to increased allocations to SWB Mobile Systems, Inc. and SWB International Holdings Corporation. Exhibit I, at the end of this report, presents a complete list of all the services provided by SBC to its affiliates, along with the method used to recover those costs. Those methods are direct assignment, retention by the parent company or indirect allocation. Indirect costs are allocated using one the following five factors:

- Average Investment Factor
- Internal Audit Factor
- Average Employee Factor
- Marketing Factor
- General Factor

Objective

45. The objective of reviewing the transactions from SBC to SWBT was to determine compliance with the affiliate transaction standards and to ensure that the telephone ratepayers had not been adversely affected by potential cross-subsidies which could flow to the nonregulated affiliates in the form of underallocations or no allocations of SBC costs to the nonregulated subsidiaries. In order to achieve this objective, the audit team had the following specific major goals:

- (a) Determine whether the Cost Allocation System (CAS) used by SBC to recover costs from subsidiaries inherently disadvantages the regulated ratepayer.
- (b) Determine whether the CAS had been implemented and was being followed correctly.
- (c) Determine whether the time reporting procedures, the primary determinant of many allocators, were reasonable and were being followed.
- (d) Determine whether other allocators could be implemented which more closely mirror benefits received by all subsidiaries.

Scope

46. Our audit covered the four years 1989 - 1992 with particular emphasis on 1992. The audit steps employed included, but were not limited to, the following:

- We reviewed internal and external audit reports related to SBC cost allocations.
- We reconciled SBC's cost recovery summary provided in the survey audit to the SBC 1992 General Ledger.
- We reviewed the written procedures associated with SBC's Cost Allocation System.
- We interviewed 43 employees to determine whether a time study had been prepared and whether a contemporaneous record existed to support SBC's allocations.
- We reviewed exception time reports to determine the extent to which employees perform duties different from their regular duties.
- We compared descriptions of functions (cost centers) and beneficiaries of those functions (charging directions) to the work actually performed by selected employees.
- We reviewed the costs which were retained and absorbed by SBC's stockholders.
- We reviewed the marketing allocator to determine the reasonableness for including costs directly incurred by the subsidiaries in calculating the marketing factor to be used in the apportionment of SBC costs to these subsidiaries.
- We reviewed the general allocator to determine reasonableness for not including parent retained costs in its development.

Audit Results

NO SUPPORTING DOCUMENTATION FOR THE CHARGING

47. SBC's Cost Allocation System (CAS) utilizes cost centers and charging directions. Cost centers are categories of costs (or functions) where similar types of expenditures are accumulated (See Exhibit 3). Charging Directions (CDs) are two-digit codes associated with Cost Centers which determine how and to whom a cost is charged.

Exhibit II, at the end of this audit report, shows a complete listing of the charging directions and codes in use during 1992. This Exhibit also illustrates the importance of the charging direction codes in the overall cost recovery process, e.g., when an employee uses CD 01, those costs are directly charged to the telephone company. The CAS is driven by surveys of time reporting by SBC's employees. Assignments of costs to both cost centers and charging directions are based on periodic time studies of employees' actual work. For example, in accordance with the CAS Users' Guide, when a new position is created or an existing position changes materially, a four-week time study is required to be performed. Based on the results of this time study, an employee's time is charged to both cost center(s) and charging direction(s), using factors which will remain, virtually unchanged, until a new time study is performed. The CAS also provides for exception time reporting, however, very little was found to exist. The CAS does not have a retention period for time studies and no time studies currently exist to support SBC cost allocations.

48. During the field work, the audit team inquired as to whether the supporting documentation for the time studies existed and the audit team was told that none were maintained. The audit team interviewed 43 SBC employees in San Antonio, Texas, none of whom could produce the required four-week time study on which their current time allocations were based. Section 32.12 (b) of the Uniform System of Accounts requires, in part, "...The detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission". The effect of SBC's lack of supporting documentation for time charging, which was ultimately reflected on SWBT's books of accounts, could not be quantified because there was no historical or contemporaneous record the audit team could use to verify that time charges were accurate for the audit period 1989 - 1992. Therefore, the dollar impact on the ratepayers is indeterminable. Although all SBC employees who were interviewed responded in the affirmative that their actual time charging was representative of their work effort, the audit team, nonetheless, had no alternative but to either accept that claim wholly on faith or to reject it.

49. The lack of historical time studies is a failure by SBC to follow both its internal procedures and Part 32 - Uniform System of Accounts (USOA). SBC claims that at one time the required time studies were performed. Afterwards, when a new employee was transferred in, the cost center(s) and charging direction(s) of his/her predecessor continued since the function of the position did not change. During the course of the audit, an SBC representative informed the audit team that SBC recently made changes to the CAS which should provide better documentation for time charging in the future. This revised CAS manual, dated September 1993, was received by the audit team on November 15, 1993, after completion of the field audit work.

MARKETING ALLOCATOR

50. SBC allocates its marketing costs using a marketing allocator. As described in its CAS: "The Marketing Factor is used to allocate the costs associated with SBC's

Corporate Advertising programs and Marketing Support activities to the benefitting subsidiaries. The percentages used to apportion these costs are developed by using the amount of direct charges that have been assigned to each subsidiary within these same cost centers (CCNs 080 and 081). In addition to these direct charges, the costs that have been incurred for advertising and marketing support by each subsidiary are included for the development of the factor."

51. Cost Center (CCN) 80 - Corporate Advertising and CCN 81 - Marketing Support are the only CCNs that use the Marketing Allocator. In 1992, SBC incurred the following marketing costs:

Directly Charged Costs	Allocated Costs	Total
\$3,427,138	\$18,622,656	\$22,049,794

Of the above charges, 15.5% were directly charged to subsidiaries and 84.5% were allocated using the marketing allocator. SWBT received the following marketing-related charges from SBC:

	Direct	Allocated	Total
Corporate Advertising	\$54,175	\$4,386,354	\$4,440,529
Marketing Support	(182,386)	4,853,137	4,670,751
Total	\$(128,211)	\$9,239,491	\$9,111,280

The above numbers indicate that in 1992 SWBT received a refund of prior years direct charges for Corporate Advertising and Marketing Support combined. Nevertheless, SWBT was allocated 49.6% of SBC's allocated marketing costs. If the allocation of SBC's indirect marketing costs had followed SBC's directly-charged marketing costs, the allocation to SWBT in 1992 would have been zero, or it might have generated a refund.

52. The reason for this discrepancy is inherent in the formula used for calculating the marketing factor which includes both directly-incurred marketing costs of SBC as well as directly-incurred marketing costs of the various subsidiaries. By making this inclusion, the allocation of marketing expenses to SWBT goes from zero, or possibly less, to approximately \$9.2 million for 1992 alone. Based on the results of our audit of 1992 data, the audit team deemed it appropriate to go back and review the 1989 - 1991 allocation of marketing expenses. From this additional audit work, the audit team concludes that SBC was using the same methodology in those three years that they were using in 1992. The resulting overallocations to SWBT were as follows, in millions:

	1989	1990	1991	1992
Overallocations Resulting from the Improper Marketing Allocator	\$3.7	\$8.6	\$8.7	\$9.2

53. The total amount of overallocations for the years 1989 - 1992 was \$30.2 million. These expenses were then recorded in SWBT's books of record. In CC Docket No. 86-111, Report and Order, released February 6, 1987, instructions on how to allocate marketing expenses are given at paragraph 190. Specifically, "...We will require all costs that can be apportioned on the basis of direct assignment or cost causational attribution measures to be so apportioned. Residual marketing expenses will be divided between regulated and nonregulated activities based on the ratio of the directly assigned and attributable costs." The audit team believes SBC has interpreted this requirement incorrectly by including costs directly incurred by the various subsidiaries in developing a factor used to allocate residual marketing costs to the subsidiaries. Also, it is conceptually illogical for a company to allocate one of its costs, based not on the services it provides to an affiliate, but rather on the service the affiliate provides for itself.

IMPROPER GENERAL ALLOCATOR

54. The CAS uses a three-step process to allocate all of SBC's costs to the various subsidiaries. First, all costs which can be directly assigned are directly assigned. Second, similar costs are aggregated and an indirect allocator is used, e.g., the Average Investment Factor or the Average Employee Factor. The last step of the process allocates the remaining costs based on the combined distribution of all direct charges and investment-based and employee-based allocations.

55. During 1992, SBC incurred total costs of \$218.4 million. Of these costs, \$112.8 million were directly charged to subsidiaries, of which \$43.4 million were directly charged to SWBT, \$36.5 million were retained by SBC, and \$32.9 million were directly charged to all other subsidiaries combined. The remaining \$105.6 million were allocated to all affiliates. Of the allocated costs, 45.8%, or \$48.4 million, were allocated based on the general allocator. SWBT's share of costs allocated through the general allocator ranged from 67.9% to 71.4% based on the monthly calculation of the general allocator in 1992. The average for the year was 69.9% and this resulted in a charge to SWBT of \$33.8 million of the \$48.4 million.

56. In calculating the general allocator, costs retained by SBC were not reflected in any way by SBC. If the costs retained by SBC were included in the base for calculating the general allocator, SWBT's allocation would drop from 69.9% to 43.0% resulting in an allocation to SWBT of \$20.8 million, a reduction of \$13.0 million for 1992 alone. Since this problem also existed during the 1989 - 1991 time period, the audit team calculated the effect, which for the four-year period, is as follows, in millions:

	1989	1990	1991	1992
Overallocations Resulting from the Improper General Allocator	\$20.6	\$16.2	\$12.4	\$13.0

57. The total overallocations resulting from the improper general allocator for the years 1989 - 1992 were \$62.2 million. These expenses were then recorded in SWBT's books of record. In CC Docket No. 86-111, Report and Order, released February 6, 1987, at paragraph 156, the General Allocator is defined: "...The allocator is to be computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities, and applying that ratio to residual costs. We believe that this general allocator is responsive to a majority of the comments we have received on this issue, and will provide a reasonable method for allocating residual costs." The audit team interprets this section of the rule as being sufficiently clear that all directly-assigned costs should be reflected in the calculation of a general allocator. Costs that are retained by SBC are directly assigned to the stockholders and, as such, should be included in the calculation of the general allocator. SBC stated that it is "...conservative in retaining expenses, in many instances retaining justifiable and recoverable business expenses. This action is taken voluntarily; therefore, any revision could require a change in this position." The joint audit team believes that these costs are truly of benefit to the stockholders and not to SWBT, therefore they are appropriately retained by SBC and should be considered in the General Allocator.

REVIEW OF SBC CORPORATE RELOCATION COSTS

58. Beginning in late 1992 and continuing through early 1993, SBC relocated its corporate headquarters from St. Louis, Missouri to San Antonio, Texas. The reasons given for the move included being closer to the market experiencing the most growth. More specifically, the Texas operation with headquarters in Dallas accounts for 60% of SWBT's business. SBC's cellular telephone subsidiary is headquartered in Dallas and this company is one of the fastest-growing subsidiaries of SBC. SBC also wanted to be closer to Mexico and its investment in Telmax, which is one of the world's fastest-growing telephone companies.

59. In September 1992, SBC accrued a substantial expense to cover the anticipated costs of the move. SWBT's allocated share of this expense was more than 50%. This expense was then recorded in SWBT's books of record. SBC recorded the accrual in Cost Center Number 82 "Capital Insurance Premiums", a cost center that is not even described in the CAS. Upon inquiry, the audit team was told that this cost center was previously established but that it was not in use and the company deemed that it was easier to use it, rather than establish a new cost center or rename this cost center to something more descriptive of the actual activity. In addition, none of the existing charging direction codes or allocation factors were used in assigning the relocation costs to the various subsidiaries. Instead, a unique allocator was used for the purpose of recovering

the costs of relocating to San Antonio. This allocator has no name and the elements listed below were utilized in calculating the amount to be allocated to each subsidiary. The SWBT allocation is the result of the following:

$$\begin{aligned} & \times \quad \% \text{ SBC salaries allocated to SWBT} \\ & = \quad \frac{\% \text{ SBC total allocated charges to SWBT}}{\text{Salary Allocation Factor.}} \\ & + \quad \text{the \% of SBC direct charges to SWBT} \\ & = \quad \text{the "Blended Rate"} \end{aligned}$$

For SWBT, the Blended Rate was 54.8%.

60. The audit team deems that the company has not provided adequate justification for these costs to be allowable and recoverable from the telephone ratepayers. Therefore, each jurisdiction may want to give further consideration to this matter.

Conclusion

61. Based on the audit work performed, the audit team concludes that SBC is not in full compliance with the affiliate transactions standards in its allocations of costs to SWBT. More specifically, (i) SBC cannot properly support the bases for its allocations of costs to its subsidiaries, which is not in compliance with Section 32.12(b); (ii) SBC uses a Marketing Allocator that improperly allocates costs to the ratepayers, which is not in compliance with CC Docket No. 86-111, Report and Order; and, (iii) SBC calculates its General Allocator improperly, which is not in compliance with CC Docket No. 86-111, Report and Order. Depending on SWBT's earnings and the regulatory process in each of the six regulatory jurisdictions, the telephone ratepayers may have been burdened by a potential \$82.4 million in overallocations resulting from transactions with SBC during the period 1989 - 1992. In addition, the audit team deems that SBC has not provided adequate justification for charging its relocation costs to SWBT.

B. REVIEW OF TRANSACTIONS FLOWING FROM SOUTHWESTERN BELL ASSET MANAGEMENT, INC. TO SOUTHWESTERN BELL TELEPHONE COMPANY

Summary

62. The audit team has completed its review of the transactions for services sold by Southwestern Bell Asset Management, Inc. (AMI) to Southwestern Bell Telephone Company (SWBT). Our review encompassed the following AMI lines of business: Home Relocation Services; Design Services; Lease Services; and, Majestic Associates. These lines of business comprised over 98% of total SWBT purchases from AMI during 1992. Our examination included a review of AMI and SWBT policies and procedures and tests of selected transactions.

63. Based on the audit work performed the audit team concludes that there are misinterpretations of the applicable affiliate transactions standards, inequitable billing practices, and internal weaknesses. Although these problems may not have a material impact on the ratepayers, SBC's affiliates may have unfairly benefited from these practices and weaknesses in internal control. The most significant facts encountered were as follows:

a. SWBT recorded charges for office space leased from AMI at more than prevailing market price. For the period 1989 - 1992, AMI leased office space to SWBT at three locations. At two of these locations, Pinehollow in Houston, Texas and Centerpoint in Arlington, Texas, AMI rented office space to SWBT at fully distributed cost (FDC) when a prevailing market price (PMP) rate had been established. At these two buildings, more than 40% of the total space was rented to nonaffiliated third parties at an average price per square foot lower than that charged to SWBT. This practice is contrary to the affiliate transactions rules which require that rates no greater than PMP be charged and recorded in SWBT's regulated accounts when a substantial third-party market exists. The audit team estimates the effect of this misinterpretation of the affiliate transactions rules to be higher rent charges to SWBT of approximately \$92,000 for the period 1989 - 1992.

b. The cost of unoccupied rooms at the Hotel Majestic are charged to SWBT. SBC, the parent company, has an agreement with the Hotel Majestic, in which AMI has an ownership interest, whereby 40 rooms are reserved for 4 days a week for 42 weeks and an additional 10 rooms are reserved for 365 days for SBC's employees and guests at \$80 per day per room. In accordance with the terms of this agreement, SBC agrees to pay the charges for unoccupied reserved rooms. Instead, the Hotel Majestic bills SWBT monthly for unoccupied reserved rooms. These charges are then recorded by SWBT in Account 6730 General and Administrative. The audit team concludes that a portion of these charges could have been allocated by SBC to SWBT, but could not determine with specificity how much, because the Hotel Majestic was not able to provide information regarding the number of rooms rented by affiliates and SWBT. Overall, the audit team

determined that approximately \$776,000 in unoccupied room charges were billed to SWBT during the period 1989 - 1992.

c. The cost of room rate differentials at the Hotel Majestic were charged to SWBT. When an SBC guest, who can be an employee of any affiliate of SBC, made the hotel reservations through Travel Services, which is a division of SWBT, the Hotel charged the SBC guest \$65 for weekdays and \$49 per day on weekends. The difference between the contract rate of \$80 and the amount paid was charged to Travel Services and booked in the regulated General and Administrative account. During the period 1989 - 1992, the audit team determined that approximately \$261,000 of these room rate differentials were charged to SWBT. The audit team was advised by SWBT that these rate differential billings had been discontinued in September 1993, during the audit team's review. The audit team could not determine with certainty how much of the above amount would have been appropriately charged to SWBT because, again, the records maintained by the Hotel Majestic did not provide for summaries of amounts charged to each affiliate.

d. The weekend room rate charged at the Hotel Majestic is higher than prevailing market price. The prevailing weekend rate per room charged by the Hotel Majestic is \$49 per day. The rate charged for the 10 rooms which are also reserved for the weekend is \$80 per day. This practice is contrary to the affiliate transactions rules which require that SWBT record charges in its regulated accounts at no greater than PMP when a substantial third-party market exists. The maximum potential effect of SWBT recording charges in its regulated accounts in excess of PMP for weekend rates during 1989 - 1992 is approximately \$130,000.

Background

64. AMI was established as a subsidiary of Southwestern Bell Corporation in August, 1984. As of the end of 1992, AMI employed 73 people. AMI currently provides services to SWBT under the following lines of business:

a. Home Relocation Services. AMI provides various home relocation services to employees of SWBT and other affiliates who are transferring to other locations. These services include home acquisitions and sales, and employee counseling.

b. Commercial Real Estate Brokerage Services. These services include real estate market searches, site acquisitions, marketing excess real estate properties, acquisitions and sales, lease negotiations and real estate counseling. AMI provides these services to SWBT, other affiliates, and nonaffiliates.

c. Design Services. AMI provides design and architectural services to SWBT, other affiliates, and nonaffiliates.

d. Lease Services. AMI leases office space in buildings owned by AMI to SWBT, other affiliates, and nonaffiliates.

In addition to AMI's lines of business described above, AMI provides services to SWBT through its subsidiary, the Golf Club of Oklahoma, and through Majestic Associates, a Limited Partnership:

e. The Golf Club of Oklahoma. This subsidiary of AMI provides club memberships and services, e.g., food service, lodging, etc., to SWBT, other affiliates and third-party customers. It also provides promotional items from the Club's pro shop.

f. Majestic Associates. Majestic Associates provides a block of hotel rooms at the Hotel Majestic in St. Louis which are available for use by employees and guests of SWBT and other affiliates. The Hotel Majestic also rents rooms to the general public.

65. The total amounts billed by AMI to SWBT during the period 1989 - 1992 are summarized below, in millions:

	1989	1990	1991	1992
Total Billings by AMI to SWBT	\$8.8	\$7.2	\$8.0	\$12.6

The majority of the substantial increase in the billings by AMI to SWBT in 1992 was in the area of Home Relocation Services. The major reason for this increase was a 56% increase in home sales over the number of home sales in 1991.

Objective

66. The overall objective of the audit team's analysis was to determine compliance with affiliate transactions standards and ensure that the telephone ratepayers were not adversely affected by the transactions by AMI with SWBT for the years 1989 - 1992. In order to determine if the ratepayers were adversely affected by cross-subsidies caused by overcharges or misallocations of costs, the audit team had the following specific major goals:

- a. Determine whether AMI had established a substantial third-party market for the same services that it provided to SWBT.
- b. Determine whether AMI was charging fully distributed costs (FDC) for those services that it provided exclusively, or almost exclusively, to SWBT and affiliates, and was charging prevailing market prices (PMP) for those services where it had established a substantial third-party market.
- c. Determine whether SWBT was recording AMI charges in accordance with applicable rules and SWBT's established operating practices.

Scope

67. The audit team selected the following lines of business to review: Home Relocation Services; Design Services; Lease Services; and, room rentals at the Hotel Majestic. These lines of business together comprised over 98% of the total SWBT purchases from AMI during 1992. The following procedures were used to achieve the above stated objectives:

- a. The audit team determined if a substantial third-party market existed for each selected service. Where a substantial third-party market existed for AMI's service, the following procedures were used to determine if AMI was charging market prices:
 - Prevailing market price was determined based on amounts billed to third-party customers who purchased a similar quantity of comparable services from AMI during 1992.
 - The amount charged to SWBT for the service was compared to the prevailing market price charged to third-party customers.
 - For any amounts charged to SWBT above the PMP, a review was made of the amount recorded on SWBT's books to determine if the amount above PMP was properly recorded in below the line accounts.
- b. Where a substantial third-party market did not exist for the service AMI provided to SWBT, the following procedures were used to determine if AMI was charging FDC-based prices:
 - A review was made of AMI's FDC calculations to determine if FDC had been calculated in compliance with FCC cost allocation standards (45 CFR 64.901).
 - A review was made to determine if AMI charges to SWBT exceeded FDC.
 - A review was made to determine if AMI's charges in excess of FDC were properly recorded by SWBT to nonregulated accounts.

- c. A review was made of assets and products sold to SWBT by AMI to determine if pricing complied with FCC standards and SWBT's Cost Allocation Manual (CAM) and Operating Practices.

Audit Results

LEASE SERVICES

68. AMI leased office space to SWBT at 14 South Fourth Street in St. Louis, Missouri during 1989 - 1992, at Pinehollow in Houston, Texas during 1992, and at Centerpoint in Arlington, Texas during 1991 and 1992. As a part of the lease contracts, AMI also provided building-related services such as utilities, janitorial services, and after hours guard services. The revenues received by AMI from SWBT and other affiliates for office leases are summarized below, in millions:

	1989	1990	1991	1992
SWBT	\$2.4	\$2.4	\$2.9	\$3.4
Other Affiliates	0	2	1.0	1.9

69. The audit team reviewed lease payments made in 1992 for the Pinehollow and Centerpoint buildings. The review did not include the 14 South Fourth Street building in St. Louis due to the fact that SWBT is no longer leasing space in this building. Tenant information for the two buildings reviewed during 1992 is as follows:

Pinehollow, Houston (27 tenants)	Approximate Square Feet	Average Lease Rate
SWBT	20,000	12.62 / sq. ft.
Other Affiliates	60,000	11.25 / sq. ft.
Nonaffiliates	45,000	10.14 / sq. ft.

Centerpoint, Arlington (9 tenants)	Approximate Square Feet	Average Lease Rate
SWBT	63,000	11.63 / sq. ft.
Nonaffiliates	64,000	11.50 / sq. ft.

70. From the preceding data, the audit team concludes that a substantial third-party market existed for the lease services at these buildings. Approximately 40% of total space was rented to nonaffiliated third parties at these buildings and the audit team considered this percentage, based on current rules, sufficient to warrant the utilization of PMP. A PMP per square foot had been established at each of these two locations. Therefore, SWBT should have recorded charges for these lease payments at no greater than PMP in accordance with FCC standards. AMI, instead, was charging SWBT, and SWBT was recording into its regulated accounts, a lease rate per square foot based on FDC which was higher than PMP. Based on the review, the audit team believes that SWBT was charged and had recorded, in its regulated accounts, amounts in excess of those allowed by FCC affiliate transactions standards for the space leased in the Pinehollow and Centerpoint office buildings of approximately \$92,000 for the period 1989 - 1992.

MAJESTIC ASSOCIATES

71. AMI has an ownership interest in Majestic Associates, a limited partnership, which owns the Hotel Majestic in St. Louis, Missouri. The Hotel Majestic rents rooms to SBC guests (employees or guests of SBC and affiliates) and to the general public. It has a total of 96 rooms. Although room rates may vary, generally the Hotel charges a corporate rate of \$130 per day per room during the week and \$49 per day on weekends. The Hotel also offers special rates for business groups which have varied from \$85 to \$115. A contract between SBC and Majestic Associates, originally dated July 5, 1985, provides for a reserved block of rooms to be available at the Hotel Majestic for SBC guests. This contract specifies that 40 rooms are to be reserved for four days per week for 42 weeks and another 10 rooms are to be reserved for 365 days per year at \$80 per day per room. This amount per room is to be paid whether or not the rooms are used by SBC guests. The audit team reviewed the Hotel Majestic's contract, procedures and billings, and noted the following misinterpretations of affiliate transactions standards, inequitable billing practices, and internal weaknesses:

a. The agreement between the Hotel Majestic and SBC states that SBC agrees to pay the charges for the unoccupied rooms. Instead, the Hotel Majestic bills SWBT monthly for unoccupied reserved rooms. These charges are then recorded by SWBT in Account 6720 General and Administrative and recovered from the general body of ratepayers. The audit team concludes that a portion of these charges could have been allocated to SWBT, but could not determine with specificity how much, because the Hotel Majestic was not able to provide information regarding the number of rooms rented by affiliates and SWBT. Overall, the audit team determined that approximately \$776,000 in unoccupied room charges were billed to SWBT for the period 1989 - 1992.

b. When an SBC guest booked a room at the Hotel Majestic through Travel Services, a division of SWBT, the Hotel charged the SBC guest \$85 for weekdays and \$49 per day on weekends to be paid by the SBC guest's appropriate company.

SWBT, through its Travel Services Division, was charged the difference of \$15 per day (weekdays) and \$31 per day (weekends) to arrive at the total contract rate of \$80 per day. These rate differentials were booked by SWBT into Account 6720 General and Administrative. For the period 1989 - 1992, SWBT was charged approximately \$261,000 for these room rate differentials. Again, the audit team could not determine with specificity how much of these charges could have been allocated to SWBT, since the Hotel Majestic was unable to provide information regarding the number of rooms rented by affiliates and SWBT. SWBT advised the audit team that these rate differential billings to SWBT's Travel Services Division had been discontinued in September 1993, again during the audit team's review.

c. The audit team takes no exception with the room rate charged during the week. However, the audit team concludes that the weekend rate charged to SWBT, which is also recorded in SWBT's regulated books of accounts, is not in conformance with the affiliate transactions rules. The prevailing weekend rate per room charged is \$49 per day. The rate charged for the 10 rooms reserved for the weekend is \$80. Since a substantial third-party market exists for room rentals to the general public, the audit team considers this practice to be contrary to the affiliate transactions rules which require that a rate no greater than PMP be recorded into SWBT's regulated accounts. The audit team estimates the maximum potential effect of SWBT recording charges in its regulated accounts in excess of PMP on weekends during 1989 - 1992 to be approximately \$130,000. The audit team was unable to determine the exact effect of this infraction due to the fact that the Hotel was not able to provide information regarding the number of rooms rented to employees of affiliates as well as SWBT.

d. SWBT's Operating Practice 125 at section 8.110 through 8.113 requires SWBT affiliates to provide cost information related to PMP and FDC on the invoices for assets or services provided to SWBT. In addition, SWBT personnel receiving invoices for affiliate transactions must review the invoice to verify the cost information. The Hotel Majestic was not in compliance with these internal procedures, since it did not include this cost information on its invoices to SWBT. The audit team deems this information essential for SWBT to comply with internal operating practices, and for SWBT to properly record charges in its regulated accounts.

HOME RELOCATION SERVICES

72. AMI provides home relocation services and assistance to employees of SWBT and other affiliates who are relocating. AMI does not provide home relocation services to third parties. The employees who are relocating may elect to sell their homes under one of three options. Under Option 1, or Regular Home Sales, AMI actually purchases the home from the employee and assumes all costs associated with the sale of the property including acquisition costs, selling costs, interest, maintenance and repairs, and losses or gains on the sale of the homes. Under Option 2, or Assigned Home Sales, the employee has a buyer for his/her home. AMI pays the employee up front for the owner's equity and acts as an agent to handle the sale. Under Option 3, AMI acts as a consultant and provides relocating advice and counselling services only.

73. Prior to 1992, AMI charged a flat service fee per home to the affiliate to cover AMI's administrative costs for both types of sales services, i.e., regular home sales and assigned home sales. The amount of the service fee was \$1,900 in 1989 and 1990, and slightly higher in 1991 for both types of services. When the home was sold, AMI billed the affiliates the actual costs associated with both the purchase of the home from the employee as well as its sale to other parties. These expenses included acquisition costs, interest, taxes, maintenance, repairs, selling costs, and losses or gains on the sale of the homes by AMI. These actual costs were recorded on AMI's books in balance sheet accounts. The only amount recorded as income by AMI for these services was the flat service fee.

74. In 1992, these procedures and fees remained the same for sales where AMI acted as the agent; however, AMI began charging SWBT a fee based on a percentage of the purchase price (or guaranteed value) for the homes it actually purchased under Option 1. This service fee includes not only AMI's administrative expenses, but also other expenses, such as interest, home maintenance, closing costs, and losses on the sale of the homes. The entire service fee collected from the affiliates, as well as the proceeds from the sale of the home, were recorded as income during 1992. The revenues received by AMI for home relocation services provided to SWBT and other affiliates are shown below, in millions:

	1989	1990	1991	1992
Total Service Fees	\$1.3	\$2.9	\$1.1	\$7.0
Home Sales	0	0	0	16.1
Total Revenue	\$1.3	\$2.9	\$1.1	\$23.1

75. Since home relocation services were provided only to SWBT and other affiliates, these services should be recorded in the regulated accounts at no greater than

FDC, pursuant to FCC affiliate transactions regulations. Based upon AMI's calculations of FDC for the years 1989 - 1992, SWBT concluded that the charges for home relocation services were below FDC; therefore, the amounts charged could also be recorded in the regulated accounts. The audit team reviewed AMI's home relocation services contracts, billings, and FDC calculations for the years 1989 - 1992 and noted the following internal weaknesses, and errors in the calculation of FDC for 1992:

a. AMI's 1992 targeted FDC calculations for sales where the homes were purchased by AMI included home inventories in the calculation of the factor used to allocate AMI's rate base items to this line of business. Home inventory should not be used in the calculation of this factor based on the audit team's interpretation of the FCC Order on Reconsideration, Docket CC 86-111, at paragraph 78, which states that "[c]ost of goods sold, when it is used in the sense of items purchased for resale, should be excluded from the expenses that contribute to the derivation of the general allocator.... We do not believe that cost of goods sold bears any relationship to the type of operating expense we had in mind in fashioning the general allocator". The audit team believes that this rule applies in the instant case. In addition, AMI was allocating accounts receivable and accounts payable to the rate base of this type of service when direct assignment would have been more appropriate. The audit team believes that these practices could increase the targeted revenue requirement for this type of service. However, because the amount was deemed not material by the audit team, the actual effect on AMI's achieved revenue requirement was not reviewed.

b. SWBT was not a party to the original Home Relocation Services Agreement. This contract was executed between AMI and SBC. Likewise, the amendment to this contract which increased the fee for Option 1 Regular Sales to a fee based on a percentage of the purchase price of the homes in 1992 was signed by a representative of SBC. SWBT's Schedule of Authorizations on Affiliate Transactions, Section 3.10(b)(ii), requires the authorization of SWBT's Vice President of Procurement to establish, withdraw, or change rates for a purchasing contract for the acquisition of goods and services from any affiliate where the total increase/decrease exceeds \$300,000. The audit team considers the absence of proper authorization by SWBT as not being in compliance with SWBT's own internal policies and procedures which is an internal control weakness.

c. Home Relocations FDC calculations for 1989 and 1990 provided to the audit team by SWBT were based on estimated expenses and home sales activity. True-up calculations based on actual costs were not available. Home Relocation true-up calculations for 1992 were not made until September 1993. The audit team believes that the true-up of FDC to actual costs should be performed as soon as possible after year-end to help ensure that any necessary adjustments in the regulated accounts of SWBT are made on a timely basis. In addition, it would allow FDC for 1993 to be calculated based on 1992 actual activity.

DESIGN SERVICES

76. AMI provides commercial design services including drafting, planning, and space utilization studies to SWBT, other affiliates, and nonaffiliated third parties. The revenues received by AMI from SWBT and other affiliates for design services are summarized below, in millions:

	1989	1990	1991	1992
SWBT	\$.1	\$.3	\$.3	\$.6
Other Affiliates	\$.1	\$.9	\$ 1.3	\$ 1.0

77. In 1992, AMI received a substantial amount of its revenues for design services from nonaffiliated third parties. Based on current affiliate transactions rules, the audit team deems the amount of business transacted with third parties to be substantial. Therefore, these transactions with SWBT should be priced and booked at Prevailing Market Price (PMP). The audit team examined and compared prices charged to nonaffiliates with prices charged to SWBT for similar services. Based on this examination, the audit team concludes that SWBT is properly recording charges for these services at PMP or less in accordance with the affiliate transactions standards.

Conclusion

78. Based on the audit work performed, the audit team noted misinterpretations of affiliate transactions standards in dealings between AMI and SWBT, inequitable billing practices and weaknesses in internal control. The audit team concludes that these facts may not have a material impact on the ratepayers, but that SBC's affiliates may have unfairly benefited from these practices and weaknesses in internal control.

C. REVIEW OF TRANSACTIONS FLOWING FROM SOUTHWESTERN BELL TELECOMMUNICATIONS, INC. TO SOUTHWESTERN BELL TELEPHONE COMPANY

Summary

79. The audit team has completed its review of the transactions for services and products sold by Southwestern Bell Telecommunications, Inc. (Telecom) to Southwestern Bell Telephone Company (SWBT). Based on the audit work performed, nothing came to the attention of the audit team that would indicate that Telecom's products and services sold to SWBT were not priced and recorded in SWBT's books of record in accordance with the applicable 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 related party transactions between Telecom and SWBT for noncompliance with these standards. Our examination included reviews of policies and procedures and tests of selected transactions.

80. Telecom is a subsidiary of Southwestern Bell Corporation (SBC), the parent company of SWBT. Telecom sells telecommunications and data terminal products to large businesses, retail outlets, wholesalers, and distributors. During the period under review, 1989 - 1992, Telecom's sales to SWBT ranged from approximately \$6.0 million in 1989 to \$11.3 million in 1992. The products purchased by SWBT consisted of telephone sets, data communications equipment, and related installation, repair and maintenance services. Of the total purchases from Telecom, approximately 50% were used in the official conduct of business by SWBT and, therefore, recovered from the telephone ratepayers. The other 50% were used by SWBT in its provision of nonregulated services, such as "in-line plus". "In-line plus" is a nonregulated service offered by SWBT to its telephone subscribers for the repair and maintenance of their inside wire and the provision of loaner telephone sets while subscriber sets are being repaired.

Background

81. Telecom was incorporated in the state of Delaware in November 1983. It is a subsidiary of Southwestern Bell Corporation and an affiliate of SWBT. Telecom services both residential and business markets through two operating divisions: the Freedom Phone Division and the Business Systems Division. The Freedom Phone Division distributes basic and multiline telephones and key systems to wholesalers, distributors, and retailers throughout the United States and in 30 other countries. The Business Systems Division operates within the five-state territory of SWBT and serves primarily business customers. The products marketed by this division range from basic telephones and key systems to complex digital PBX systems, facsimile products, office equipment software, and data communications equipment. As of the end of 1992, Telecom employed approximately 300 people. Plans have also been developed to move Telecom's headquarters from St. Louis, Missouri to Dallas, Texas.

82. During the period 1989 - 1992, Telecom's sales to SWBT ranged from approximately \$6.0 million in 1989 to \$11.3 million in 1992. The products and services purchased by SWBT ranged from telephone sets to data communications equipment and related installation, repair and maintenance services.

Objective

83. The objective for reviewing the transactions of Telecom with SWBT was to determine compliance with the affiliate transactions standards and to ensure that the telephone ratepayers had not been adversely affected by potential cross-subsidies which could flow to the nonregulated affiliates in the form of overcharges by the nonregulated affiliate. To achieve this objective, our examination centered on the following goals:

- a. Determine whether Telecom had established a substantial third-party market for the same products and services that it provided to SWBT.
- b. Determine whether Telecom was charging fully distributed cost (FDC) prices for those products and services that it provided exclusively, or almost exclusively, to SWBT and market prices for those products and services where it had established a substantial third-party market.
- c. Determine whether SWBT was recording Telecom's charges in accordance with standards.

Scope

84. The examination covered reviews of policies and procedures in effect in 1992 and tests of transactions which occurred in the same year. More specifically,

- We reviewed internal and external audit reports related to Telecom's transactions with SWBT.
- We reconciled total billings from Telecom to SWBT's Form M Report for 1991 and 1992 and to SWBT's General Ledger.
- We reviewed Telecom's policies and service agreements related to transactions with SWBT.
- We examined Telecom's financial statements and performed other necessary tests to determine whether Telecom had established a substantial third-party market for the same services and products that it sold to SWBT.
- We selected invoices for services and products billed to SWBT and compared prices charged to SWBT with prices charged to nonaffiliated third parties.

- We reviewed internal controls in place at SWBT to ensure that all products and services billed by Telecom had actually been received.
- We reviewed procedures that SWBT had in place to identify those services and products purchased from Telecom that it used for internal purposes and those services and products that it sold to third parties as a nonregulated activity.
- Since the assignment of the appropriate code to input documents is essential to determine whether a cost is recorded and assigned or allocated to regulated or nonregulated activities of SWBT, we reviewed written descriptions, flowcharts, functional accounting codes and purchase order codes. We tested the flow of selected transactions through the system. This is a very complex computerized system designed to drive expenditures to the proper accounts and activities automatically.
- We reviewed the sales agency agreement. Telecom sold network services on behalf of SWBT.

Audit Results

85. An analysis of Telecom's internal financial reports indicated that SWBT purchases of products and services from Telecom comprise a relatively small percentage of Telecom's total sales volume. During the period under review, SWBT's purchases from Telecom were as follows, in millions:

	1989	1990	1991	1992
SWBT's Purchases from Telecom	\$6.0	\$7.5	\$10.3	\$11.3

86. Generally, Telecom had established a substantial third-party market for all the products it sold to SWBT, which represented the bulk of the transactions with SWBT. Of the services rendered by Telecom to SWBT in 1992, only \$236,000 were priced at fully distributed cost (FDC). The balance of the services rendered were priced at prevailing market price (PMP) because a sufficient third-party market existed to justify the charging of market prices.

87. Telecom's policy was to charge SWBT the lowest price paid by a nonaffiliated third-party during the test period for the item in question and in all cases not to exceed the PMP for a given item. Telecom's definition of PMP was the price paid by a nonaffiliated third-party in a substantial number of transactions. Telecom considers this criterion to be met when, (i) sales to nonaffiliates constitute 10% of all sales of the same products or, (ii) a single sale of the same product to a nonaffiliate amounts to \$50,000 or more. The test period for determining the PMP included transactions made in the current year to date plus

the prior calendar year. The terms and conditions of the sales of both products and services by Telecom to SWBT were covered by contractual agreements. These agreements recited Telecom's policy and how PMP was derived. The audit team takes no issue at this time with the criteria used to develop PMP, since Telecom sales were predominantly to third parties and a sufficient third-party market existed.

88. In accordance with Telecom's policy, prices for products sold to SWBT were to be revised quarterly based on sales to nonaffiliated third parties during the previous year and the current year to date. A review of the implementation of this policy revealed that Telecom periodically reexamined the sales prices charged to SWBT. However, in this reexamination of prices, Telecom excluded certain transactions with third parties which are included in "exception reports". Transactions included in these exception reports, generally, fell into four major categories:

- Clerical and administrative errors which allowed incorrect prices to be entered into Telecom's system. For example, a prorate error where a credit was inadvertently spread over all items on an invoice.
- Discounts offered to nonaffiliated third parties by Telecom for trade-ins and the upgrade of existing systems to new systems sold by Telecom.
- Reduced prices offered as a goodwill gesture to compensate a purchaser for service problems.
- Discounted prices for large purchase commitments of a system or package of products.

89. A further review of Telecom's pricing practices revealed that discounts, especially on package sales, were not isolated occurrences, but rather a normal recurring event. In the audit team's opinion, the transactions involving discounted prices for large purchase commitments of a system or package of products should be included in the determination of the PMP for the products sold to SWBT. This changed practice would produce a lower PMP to be charged to SWBT. However, because of time constraints the audit team did not quantify the effect of this practice. In addition, it would be impractical to attempt to reconstruct Telecom's sales for the audit period to reflect revised prices which incorporate volume discounts, because of the multitude of products sold.

90. The audit team's price tests revealed occasional instances where SWBT was charged prices higher than the prices charged to nonaffiliated third parties. Telecom's representatives attributed these instances to isolated clerical errors. Further price tests revealed, however, that SWBT was charged prices consistently equal to or lower than the median price charged to nonaffiliated third parties which had been considered as the prevailing market price. Telecom defined the median price as being the middle of the five lowest prices charged to nonaffiliated customers. In the audit team's opinion, although

refinements to the pricing process are undoubtedly possible, nothing came to the attention of the audit team that would suggest the parties were in violation of the applicable affiliate transactions standards.

91. During 1992, Telecom sold network services on behalf of SWBT. This service was also covered by a contractual agreement. A review of this service revealed that it was terminated at the end of 1992 and that the commissions paid by SWBT to Telecom were the same as those paid by SWBT to nonaffiliated sales agents. Therefore, the team concludes that no cross-subsidies existed in this area as the sales commissions paid were not discriminatory.

92. Finally, depending on the use of the products and services purchased by SWBT from Telecom, they can be classified as either regulated, and therefore recovered from the telephone ratepayers, or nonregulated and sold to the general public on a competitive price basis. For example, telephone sets purchased from Telecom and used by SWBT internally for the provision of official communications service would be classified as regulated and their cost recovered from the telephone ratepayers. Telephone sets used by SWBT for its "in-line plus" program would be classified as a nonregulated service. Subscribers to this program would be provided with a loaner telephone set while theirs is being repaired. Since the audit team was primarily concerned with those costs which were allocated to the regulated services of SWBT and recovered from the telephone ratepayers, the audit team reviewed the coding process of these products to ensure that they were being coded in accordance with their use and found no exceptions. In 1992, \$5.8 million, or 52%, of the \$11.2 million of the purchases from Telecom were assigned to the nonregulated operations of SWBT. Therefore, the audit team's concern was only for the difference, \$5.4 million, or 48% of purchases from Telecom. In view of the amount of purchases which were recorded above the line and recovered from the telephone ratepayers, the audit team concludes that, to the extent that some items might have been charged at prices above PMP, the effect would be immaterial.

Conclusion

93. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that Telecom's products and services sold to SWBT were not priced and recorded in SWBT's books of record in accordance with the applicable 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 related-party transactions between Telecom and SWBT resulting from noncompliance with these standards. In 1992, \$5.8 million, or 52%, of the \$11.2 million of the purchases from Telecom were assigned to the nonregulated operations of SWBT. Therefore, the audit team's concern was only for the difference, \$5.4 million, or 48% of purchases from Telecom. In view of the amount of purchases which were recorded above the line and recovered from the telephone ratepayers, the audit team concludes that, to the extent that some items might have been charged at prices above PMP, the effect would be immaterial.

D. REVIEW OF ALLOCATIONS OF COSTS OF SOUTHWESTERN BELL TECHNOLOGY RESOURCES, INC. TO SOUTHWESTERN BELL TELEPHONE COMPANY

Summary

94. The audit team has completed its review of the allocations of costs of Southwestern Bell Technology Resources, Inc. (TRI) to Southwestern Bell Telephone Company (SWBT). Our examination included reviews of policies and procedures and tests of selected allocations and projects.

95. TRI is a subsidiary of Southwestern Bell Corporation (SBC) and an affiliate of SWBT. TRI is involved in applications research, preparation of product specifications, and testing the capability of telecommunications products. TRI's billed expenses to SWBT ranged from \$12.3 million in 1989 to \$25.2 million in 1992.

96. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that TRI's cost allocations to SWBT were not made and recorded in SWBT's books of record in accordance with the applicable 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 TRI and SWBT resulting from noncompliance with these standards.

Background

97. Southwestern Bell Technology Resources, Inc. was incorporated in Delaware on January 12, 1988. It is a subsidiary of Southwestern Bell Corporation and an affiliate of Southwestern Bell Telephone Company. TRI is involved in applications research and the preparation of product specifications. TRI also performs testing and evaluations of manufacturers' designs and products to determine if the general specifications set by the various SBC subsidiaries are being met. In addition, TRI writes applications software for computers with processing systems that have been designed to be user-programmed.

98. TRI's activities related specifically to SWBT are:

- TRI assists SWBT in the development of technology strategies by anticipating, identifying and assessing opportunities and defining what technologies can be utilized by SWBT.
- TRI seeks and develops technology opportunities to fill SWBT business needs by prototyping/demonstrating new architectures, applications and services, and developing technology testbeds to gain better insight into infrastructure or market impacts.
- TRI supports the transfer of new technologies to SWBT from Bellcore and

college/university research programs.

- TRI provides general technology support to SWBT in the areas of human factors/user interfaces, standards management, intellectual properties management, and consulting and competitive analysis support on a wide variety of technologies.

99. Technology Resources operates as a cost center and bills out all of its costs to the affiliates for which services are provided. Therefore, the terms "sales" and/or "revenues" are inapplicable to TRI. Instead, the term "billed expenses" is used. TRI's billed expenses to SWBT ranged from \$12.3 million in 1989 to \$25.2 million in 1992. TRI's administrative and research facilities are located in Town and Country, Missouri, a suburb of St. Louis. During the period covered by this audit, 1989 - 1992, the work force increased from 107 to 199, respectively.

Objective

100. The objective for reviewing the allocations of TRI's costs to SWBT was to determine compliance with the applicable affiliate transactions standards and to ensure the ratepayers were not adversely affected by potential cross-subsidization of nonregulated affiliates caused by overcharges, the misallocation of costs or the misassignment of research project costs by TRI to SWBT as a result of noncompliance with these standards. The specific major goals employed by the audit team to achieve this objective were as follows:

- a. Determine whether the cost accounting system in place complied with fully distributed costing (FDC) standards.
- b. Determine whether research projects funded by SWBT were of benefit to the ratepayers.
- c. Determine whether a direct correlation existed between the research effort and the billing methodology utilized.
- d. Determine whether SWBT was recording TRI's charges in accordance with standards.

Scope

101. The examination covered reviews of policies and procedures in effect in 1992 and tests of transactions which occurred during the same period. More specifically,

- We reviewed internal and external audit reports related to TRI's transactions with SWBT.

- We reviewed TRI's General Agreement with SWBT.
- We reconciled the total billings from TRI to SWBT's Form M Report for 1991 and 1992 and to SWBT's General Ledger.
- We interviewed TRI's personnel with respect to the cost accounting system utilized to determine compliance with fully distributed costing (FDC) methodologies. We tested the implementation of such procedures.
- In order to determine if there was a direct correlation between work effort, cost accumulation and the billing process, we selected certain projects and reviewed the supporting documentation for the monthly charges to those projects and the subsequent billing to SWBT.
- We reviewed TRI's financial statements for 1992 to determine whether they included a charge for return on investment which was included in its billings to affiliates, particularly SWBT.
- We reviewed the schedules to the General Services Agreement which described each project and identified those which could relate to nonregulated activities.

Audit Results

102. The audit team reviewed the projects undertaken by TRI to determine whether the amounts billed to SWBT were computed in accordance with the required standards as were the amounts recorded in regulated accounts. During the period under review, the allocation of TRI costs to SWBT were, in millions:

	1989	1990	1991	1992
TRI's Billings to SWBT *	\$12.3	\$14.6	\$16.5	\$25.2
TRI's Billings to Other Affiliates	\$3.5	\$4.3	\$4.6	\$6.4

*Amounts differ slightly from those shown on the schedule on page 10 because of timing and accrual differences.

103. Purchases from TRI by SWBT are governed by a General Services Agreement effective October 1, 1988 and continuing until terminated by either party. Individual projects are then specifically agreed to and covered by schedules to the General Services Agreement. Each schedule contains a description of the service and deliverable, the term, price and billing identification number and other terms and conditions that may be applicable to that project. For the agreement, any and all patents, copyrights, etc. granted for intellectual property developed by TRI are issued in TRI's name.

104. TRI performs two types of projects: strategic technology projects (STPs) and client specific projects (CSPs). STPs are those projects from which it is determined all affiliates will benefit. Because of this mutual benefit, all participating affiliates share in the costs and receive the project results. CSPs are those projects which a specific affiliate has requested and defined. The specific client bears the total cost and only it receives the project result. TRI retains (does not bill) the costs of a few projects. Such projects are either performed for its own benefit or are accumulating charges prior to a decision being made at the corporate level with respect to which affiliate the project will benefit. The costs of retained projects for 1989 - 1992 were approximately \$259,000, \$32,000, \$103,000 and \$158,000, respectively. The audit team deemed these amounts to be immaterial with respect to this audit.

105. The amount and percentage distribution of total billed expenses, by project type, to SWBT for the period under review were, in millions:

	1989	1990	1991	1992
Strategic Technology	\$8.8	\$10.1	\$10.4	\$11.7
Client Specific	3.5	4.5	6.1	13.5
Strategic Technology	71.5%	69.2%	63.0%	46.4%
Client Specific	28.5%	30.8%	37.0%	53.6%

106. SWBT's rights in and royalties received from any project it funds are determined by the type of project. For STPs, SWBT receives a nonexclusive, irrevocable, royalty-free license to use the project and a proportional share, equal to its funding percentage, of any royalties generated by the licensing of the project. For CSPs, the license for use is exclusive, irrevocable and royalty-free and SWBT receives 100% of any royalties generated. There were no royalty fees received during 1992.

107. TRI uses a fully distributed cost (FDC) methodology to accumulate costs to research projects which are subsequently billed to affiliates. Salaries of research technicians are directly charged to specific projects, whether the project is an STP or a CSP. Administrative and other general costs are then allocated to all projects based on each project's percentage of directly charged salaries to total directly charged salaries. Direct expenses, such as expense reimbursements and payments for specific materials are recorded to each project. The total calculation for CSPs is complete at this point. For STPs, costs accumulated using the above described process are allocated to the affiliates using several allocators such as, investment in switches, investment in all plant and customer premise equipment (CPE), and investment in radio systems. Because TRI operates as a cost center, no return on investment factor is included in the computation of the billings. The audit team reviewed TRI's FDC methodology and found it to be in

accordance with the affiliate transaction standards contained in the Uniform System of Accounts. The team also selected specific STPs and CSPs and tested the application of the methodology. No exceptions were found.

108. The audit team reviewed and evaluated the allocators used to apportion 1992 STP costs to affiliates (those costs not directly assigned), tested the development of the 1992 allocation factors, and evaluated the propriety of the designation of 1992 STP projects. The team paid particular attention to those projects which, by their description, might benefit an affiliate more than the percentage allocation they were billed. For instance, the audit team found that the costs of STP projects related to personal communication network (PCN) research were apportioned based on a size allocator, which resulted in less than 1% of these costs being allocated to Southwestern Bell Personal Communications (SBPC). Upon further inquiry, the team found that CSP projects related to PCN were also directly assigned to SBPC. In addition, SWBT has in place a process referred to as a "look back" where it reclassifies costs to below-the-line accounts when a technology is transferred to another company. Based upon the audit work performed, nothing came to the attention of the audit team that would indicate that the allocators and the assignment of TRI's project costs to SWBT were unreasonable.

109. The audit team reviewed SWBT's procedures for recording TRI billings. Costs totalling \$105,645 for projects which were related to designated nonregulated activities were recorded "below the line" in Account 7370 Special Charges. All other projects, totalling \$25,125,710, were recorded in Account 6727 Research and Development (R&D), as prescribed by Part 32 of the Uniform System of Accounts. In accordance with the Cost Allocation Manual, the general allocator is applied to Account 6727. For 1992, the resulting percentage allocated to the regulated activities of the telephone company was 96%. As the result of continual evaluation and communication between TRI and SWBT regarding the regulated versus nonregulated status of ongoing projects, the cost of several projects which was recorded in Account 6727 Research and Development in 1992 was reclassified at the end of the year to Account 7370 Special Charges. The amount of the reclassification was \$2.3 million.

110. TRI performs research on a variety of technologies for SWBT such as digital technology, broadband, Integrated Services Digital Network (ISDN), and information technology. Due to the dynamic environment of the current telecommunications industry, these technologies may translate into services which are not yet classified as either regulated or nonregulated. The charges for such projects are recorded "above the line" in the Research and Development account. SWBT reviews projects and reclassifies them "below the line" if they are later determined to be nonregulated. For example, TRI billed SWBT \$185,481 of expenses for Visible Network Services (VNet) in 1992. SWBT recorded those charges "above the line". In 1993, VNet became a nonregulated service and SWBT reclassified the 1992 expenses "below the line".

Conclusion

111. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that TRI's cost allocations to SWBT were not made and recorded in SWBT's books of record in accordance with the applicable 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 TRI and SWBT for noncompliance with these standards. The audit team observed that improvements had been made each year to the review process associated with the classification of projects to the regulated accounts.

E. REVIEW OF TRANSACTIONS FLOWING FROM SOUTHWESTERN BELL MOBILE SYSTEMS, INC. TO SOUTHWESTERN BELL TELEPHONE COMPANY

Summary

112. The audit team has completed its review of the transactions for services and products sold by Southwestern Bell Mobile Systems, Inc. (SBMS) to Southwestern Bell Telephone Company (SWBT). Based on the audit work performed, nothing came to the attention of the audit team that would indicate that SBMS' cellular telephone services and cellular telephone products sold to SWBT were not priced and recorded in SWBT's books of record in accordance with the applicable 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 related party transactions between SBMS and SWBT as a result of noncompliance with these standards. Our examination included reviews of policies and procedures and tests of selected transactions.

113. SBMS is a subsidiary of Southwestern Bell Corporation (SBC), the parent company of SWBT. SBMS sells cellular telephone air time service, cellular telephone equipment, and related services to individual customers, nonaffiliated businesses, and SWBT. Sales of services and products to SWBT ranged from \$1.4 million in 1989 to \$2.2 million in 1992.

Background

114. Southwestern Bell Mobile Systems, Inc. was incorporated in the states of Delaware and Virginia. SBMS is a subsidiary of Southwestern Bell Corporation and is 100 percent owned by SBC. SBMS is an affiliate of Southwestern Bell Telephone Company and is operated as a stand-alone entity. SBMS was formed in 1983 to provide cellular mobile phone service. Headquarters for SBMS are located in Dallas, Texas. SBMS employed approximately 2,500 people as of the end of 1992.

115. SBMS has experienced rapid growth since its formation in 1983. On December 31, 1992, SBMS had approximately 1.4 million customers. As of June 30, 1993, SBMS had in excess of 1.8 million customers. In terms of numbers of customers served, SBMS ranks fourth nationally in the cellular market. SBMS operates in 80 markets which include both Metropolitan Service Areas (MSAs) and Rural Service Areas (RSAs). In addition to the cellular properties SBMS owns in the five-state region served by SWBT, SBMS owns properties under the name Cellular One in Chicago, Illinois; Gary, Indiana; Boston/Worcester, Massachusetts; Washington D.C.; and, Baltimore, Maryland. SBMS serves five of the top fifteen cellular markets in the United States.

116. SBMS provides three basic services: cellular telephone service; cellular telephone equipment sales; and, related cellular services which include installations, repairs, programming, custom calling features, detailed billing, etc. The SWBT Cost Allocation Manual requires that cellular telephone services and mobile telephone sets are to be offered to SWBT at prevailing market price in accordance with the affiliate transactions standards. A service agreement between SBMS and SWBT stipulates the terms under which the services are rendered and equipment is sold.

117. SBMS may also assist SWBT in regulatory proceedings by producing information in the custody and control of SBMS on an as-requested basis. These services are to be provided to SWBT on a Fully Distributed Cost (FDC) basis. Because regulatory proceedings services are not required at regular intervals, they were not reviewed by the audit team during the course of this joint audit. Aside from regulatory proceedings services, SBMS does not provide any other services exclusively, or almost exclusively, to SWBT that are not offered to the general public. Hence, there are no other SBMS services priced at FDC. During the period under review, total billings by SBMS to SWBT were as follows, in millions:

	1989	1990	1991	1992
Total Billings by SBMS to SWBT	\$1.4	\$2.0	\$2.2	\$2.2

Objective

118. The objective for reviewing the transactions between SBMS and SWBT was to determine compliance with the applicable affiliate transactions standards and to ensure that the telephone ratepayers have not been adversely affected by potential cross-subsidies which could flow to nonregulated affiliates in the form of overcharges to SWBT by the nonregulated affiliate (SBMS) as a result of noncompliance with these standards. To achieve this objective, our examination focused on the following specific major goals:

- a. Determine whether SBMS had established a substantial third-party market for the same services and products that it provides to SWBT.
- b. Determine whether SBMS charged FDC prices for those services that it provided exclusively, or almost exclusively, to SWBT.
- c. Determine whether SBMS charged market prices for those services where it had established a substantial third-party market.
- d. Determine whether SWBT was recording SBMS's charges in accordance with standards.

Scope

119. The examination covered reviews of policies and procedures in effect in 1992 and tests of transactions which occurred in the same year. More specifically,

- We reviewed internal audit reports related to SBMS's transactions with SWBT.
- We reconciled the total billings from SBMS to SWBT's Form M Report for 1992 and to SWBT's General Ledger.
- We reviewed SBMS's policies and service agreements related to transactions with SWBT.
- We examined SBMS's financial statements and performed other necessary tests to determine whether SBMS had established a substantial third-party market for the same services and products that it sold to SWBT.
- We selected invoices for services and products billed to SWBT and compared prices charged to SWBT with prices charged to nonaffiliated third parties. For this purpose, we selected some of the largest markets within SWBT territory, i.e., Dallas/Fort Worth, Kansas City, Oklahoma City, and St. Louis.
- We reviewed internal controls in place at SWBT to ensure that all products and services billed by SBMS had actually been received.

Audit Results

120. Initial audit activities focused on making a determination whether SBMS had established a substantial third-party market for the same services and products that it provided to SWBT. In making this determination, two areas were considered: total billings by SBMS and total numbers of customers. In 1992, SBMS had revenues of approximately \$2.2 million from SWBT, which represented a very small amount of its total revenues. In terms of the number of customers, at the end of 1992 SBMS had approximately 1.4 million customers, of which 1,486 were accounted for by SWBT users. Given these statistics, SBMS is deemed by the audit team to have established a substantial third-party market for the services and products that it sold to SWBT.

121. Other audit efforts centered on determining whether SBMS charged FDC prices for those services and products that it provides exclusively, or almost exclusively, to SWBT and market prices for those services where it has established a substantial third-party market. Aside from regulatory proceedings services, SBMS does not provide any services exclusively, or almost exclusively, to SWBT that are not offered to the general

public. Hence, there are no other services priced at FDC. SBMS's definition of prevailing price follows:

"A Prevailing Price is the price paid for an asset by nonaffiliated third parties in a substantial number of transactions. The test period for determining a substantial number of transactions is the current year to date plus the prior calendar year. The "substantial number" of transactions criterion is met in a relevant market area (relevant market area being appropriate only if the affiliate uses different prices in different market areas for the same products or services) when the following factors exist:

1. Sales transactions to nonaffiliates constitute 10 percent of all sales transactions of the asset within a minimum of five such sales; or
2. There is a single sale of the asset to a nonaffiliate with a gross sale price of \$50,000 or more."

122. The audit team takes no issue at this time with the SBMS's criteria since audit activities revealed that the preponderance of the business was with nonaffiliated third parties. The audit team randomly selected and tested invoices from four different markets that SBMS serves within SWBT's jurisdiction, viz., Dallas/Fort Worth, Kansas City, Oklahoma City, and St. Louis. These invoices were scrutinized for services and products billed by SBMS to SWBT and to nonaffiliated third parties. The prices charged to SWBT were compared to the prices charged to nonaffiliated third parties and were found to be equal to those prices charged to nonaffiliated third parties. In regard to this conclusion, two important considerations are noted below:

a. The provisioning of cellular telephone service is, at most, a duopoly whereby there are two competitors in a service area or market. Given the inherent competition created by a duopoly market structure, SBMS has the flexibility to and does price cellular telephone service so as to keep pace with its competition. Hence, the prices charged SWBT in one market may not be, and in most cases are not, the same as the prices for cellular telephone service in another market. Cellular service price revisions may become necessary to meet a competitor's price reduction in a particular market. When such a price revision becomes necessary, the request is reviewed by SBMS management and is finally approved or rejected by the SBMS president.

b. Many different cellular telephone service rate plans are available to both SWBT and to all nonaffiliated third parties in each market. These plans range from basic packages to comprehensive plans. The most basic plans may include only a monthly access charge and do not include air time or related services. Cellular air time usage with such a basic plan is then billed at the applicable per minute of use rate. The comprehensive plans not only include the monthly access charge, but also include cellular

air time allowances and other related services. The existence of numerous cellular service rate plans made the comparison of prices charged by SBMS to SWBT and prices charged to nonaffiliated third parties difficult. The various rate plans available to SWBT, along with the additives for related cellular services, are outlined in a service agreement between SBMS and SWBT. Testing of invoices and comparison of prices charged to SWBT and prices charged to nonaffiliated third parties revealed that the prices charged by SBMS to SWBT, generally, matched those prices charged others.

123. SBMS also sells cellular telephone equipment to SWBT. Like cellular telephone service, the prices for the cellular equipment available to SWBT are listed in a service agreement. The audit team reviewed sales logs for cellular telephone equipment in the four markets being examined, viz., Dallas/Fort Worth, Kansas City, Oklahoma City, and St. Louis. The sales of cellular telephone equipment to SWBT were compared to sales of like equipment to nonaffiliated third parties. The audit team observed that the prices charged for cellular telephone equipment sold by SBMS to SWBT were, generally, equal to or lower than the prices charged to nonaffiliated third parties. Given the above listed facts, the audit team concludes that, in general, cellular telephone services and cellular telephone equipment sold to SWBT by SBMS were both sold at the same price, or lower, than that offered nonaffiliated third-party customers.

Conclusion

124. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that SBMS' cellular telephone services and cellular telephone products sold to SWBT were not priced and recorded in SWBT's books of record in accordance with the applicable 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 related party transactions between SBMS and SWBT resulting from noncompliance with these standards.

F. REVIEW OF TRANSACTIONS FLOWING FROM SOUTHWESTERN BELL TELEPHONE COMPANY TO AFFILIATES

Summary

125. The audit team has completed its review of the transactions for nontariffed services and sales of assets made by Southwestern Bell Telephone Company (SWBT) to affiliates. Our examination included reviews of policies and procedures, service agreements, methodology for development of cost studies, and tests of selected transactions, particularly, for the following non-tariffed services: technical personnel services; data processing services; real estate management; temporary labor; SWETN services (official communications); public relations; and, business office support. These services, together with the sales of assets, which were also reviewed by the audit team, represented 65% of the total amount billed for nontariffed services by SWBT to affiliates in 1992.

126. 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 resulting from noncompliance with these standards. SWBT's services were priced to recover at least fully distributed cost (FDC), when a tariff or prevailing market price (PMP) was absent. Assets sold by SWBT to affiliates were accounted for at the higher of fair market value (FMV) or net book value (NBV). SWBT reviews the pricing of services yearly. Its procedures are constantly modified and formalized.

127. SWBT is the largest subsidiary of Southwestern Bell Corporation (SBC). It provides telephone service in the states of Arkansas, Kansas, Missouri, Oklahoma, and Texas. The nontariffed services rendered to affiliates are mostly of an administrative or staff support nature. The assets sold to affiliates during the audit period, which covered 1989 - 1992, were mostly office furniture and equipment. Amounts billed by SWBT to affiliates ranged from \$25.7 million in 1989 to \$38.7 million in 1992.

Background

128. Southwestern Bell Telephone Company (SWBT) was incorporated in Missouri on August 24, 1982. SWBT is a telecommunications common carrier providing telephone service to approximately 8.4 million residential and 1.4 million business customers in the states of Arkansas, Kansas, Missouri, Oklahoma, and Texas. As of December 31, 1992, SWBT employed approximately 50,000 people, which represented approximately 84% of the total employees of Southwestern Bell Corporation (SBC), the

parent company, and had assets of \$17.9 billion, representing approximately 75% of the total assets of SBC. For the year ended December 31, 1992, SWBT had approximately \$7.7 billion in revenues, or approximately 77% of the total revenues of SBC.

129. During 1992, SWBT was restructured into three units: SWBT of the Midwest serving the states of Arkansas, Kansas, Missouri, and Oklahoma; SWBT of Texas serving the state of Texas; and, SWBT Services providing centralized support services to the other two units. In 1993, SWBT was once again restructured, this time into two operating divisions called Customer Services and Network Services. Customer Services is responsible for managing customer and sales efforts. While Network Services is responsible for planning, designing, engineering, and construction of the telecommunications network. Company representatives explained that SWBT reorganized along functional lines in order to be better able to respond to an increasingly competitive telecommunications market.

130. SWBT provides over 50 nontariffed services, mostly of an administrative or staff support nature, to affiliates. These services are provided utilizing existing resources to maximize efficiencies and are considered incidental to the main telephone operations of SWBT. The table below provides the total amounts billed for nontariffed services and for incidental sales of assets to each affiliate during the audit period, 1989 to 1992.

Amounts Billed by SWBT to Affiliates
(In millions)

<u>Affiliate</u>	1989	1990	1991	1992
SBC (Parent Company)	\$13.1	\$14.1	\$15.2	\$14.2
SWB Yellow Pages, Inc.	1.8	10.1	10.7	9.5
SWB Telecom, Inc.	.9	3.9	4.3	3.0
SWB Publications, Inc.	6.2	.5	.7	.5
SWB Technology Resources, Inc.	.2	.2	.1	6.5
SWB International Holdings, Inc.	0	0	.8	.9
SWB Mobile Systems, Inc.	.5	.6	1.1	1.3
SWB Redevelopment Corporation	.2	.5	.6	.1
Metromedia Paging Services	0	0	.3	.4
SWB Printing Company	0	0	0	.1
SWB Asset Management, Inc.	.1	.1	0	.1
SWB Int'l Development Corporation	0	.1	.3	0
SWB Enterprises, Inc.	0	0	0	2.1
Media, Inc.	2.7	0	0	0
Total	\$25.7	\$30.1	\$34.1	\$38.7

Objective

131. The objective for the audit team's review of SWBT's nontariffed transactions with its affiliates was to verify that the transactions were completed in accordance with the applicable affiliate transactions standards indicated in this report and to ensure that the regulated activities were not subsidizing any nonregulated activities through noncompliance with these standards. Cross-subsidies could occur in the form of undercharges or no charges at all for services and products sold to affiliates by SWBT. To achieve this objective, our examination focused on the following specific major goals:

- a. Determine whether services provided by SWBT to affiliates were priced and recorded in accordance with the affiliate transactions costing standards.
- b. Determine whether transfers or sales of assets to affiliates were priced and recorded in accordance with the affiliate transactions costing standards.
- c. Determine whether revenues received from the sale of assets and services to affiliates were recorded in above the line regulated accounts.

Scope

132. The audit work was primarily concentrated on 1992 activities. For this purpose, the audit team selected for review seven services and the assets sold to affiliates in 1992. Together, the selections accounted for approximately 65% of total nontariffed transactions billed to affiliates for the year 1992, see table below, presented in millions.

Services Selected for Review

	1989	1990	1991	1992
Technical Personnel Services	\$1.3	\$1.7	\$1.7	\$.9
Data Processing Services	2.6	2.5	3.0	3.0
Real Estate Management	8.5	8.9	8.3	9.3
Temporary Labor	.9	.5	1.5	1.2
SWETN Services	2.6	2.5	4.0	3.7
Public Relations	.5	1.0	1.0	.9
Business Office Support	.2	.5	.7	1.0
Asset Transfers	.2	.0	1.0	5.2
Total Services Selected for Review	\$16.8	\$17.6	\$21.2	\$25.2
Total Amounts Billed by SWBT to Affiliates	\$25.7	\$30.1	\$34.1	\$38.7
Percentage of Total Services Selected for Review	65.4%	58.5%	62.2%	65.1%

133. The audit process followed involved three major steps: first, the review of SWBT's affiliate transactions policies and procedures; second, the testing for compliance

and effective implementation of the procedures; and, third, the identification and quantification of deficiencies, if any. 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 the Form M 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.
- We reviewed costing of services to ensure that all direct and indirect costs were included.
- 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.

Audit Results

134. The affiliate transactions reviewed by the audit team in this portion of the audit involved activities which SWBT performed internally for its own benefit and also provided to affiliates using, primarily, existing resources. The guiding principle for providing these services for itself as well as for affiliates is efficiency, avoidance of duplicate resources, and maximization of cost savings. When properly administered, the audit team concurs that centralization and the sharing of resources can be of benefit to all parties concerned.

135. At SWBT, a contract process is used to provide these nonaffiliated services to affiliates, as opposed to a cost sharing process. This contract process associates each service with a billable unit, e.g., hour, employee, page. Each billable unit has an identifiable cost and a price. SWBT has a General Service Agreement (GSA) with each affiliate to which it renders these services. The GSA defines the business relationship and

the general terms and conditions under which SWBT will provide the services. Detailed description of services, together with the duration of the contract, specific terms and conditions, are contained in "Schedules" which are attached to the GSAs. Attached to these schedules are pricing addenda which state the prices in effect at any given time. These prices are reviewed yearly and revised, if necessary. The audit team's review of these pricing addenda revealed that, generally, the stated price is equal to or greater than fully distributed cost (FDC), in compliance with the FCC affiliate transactions standards.

136. SWBT develops FDC for each service by first identifying all direct capital costs and operating expenses and, second, by identifying all direct labor costs involved. Following this process, SWBT develops loading factors for common overhead which are applied to each respective type of cost (capital or labor) to arrive at FDC. At this point, SWBT develops two types of unit cost for each service: one without the common overhead, which is referred to as incremental unit cost (IUC); the other with common overhead and referred to as FDC. Finally, SWBT assesses the market for similar services and determines the price that the affiliate should pay for a given service. This price is usually market, if higher, but in no event shall be lower than FDC. The audit team concludes that the IUC is of no value except, perhaps, to identify the direct cost involved in the provision of a particular service. Furthermore, the audit team makes no judgment as to the appropriateness of the methodology employed in the cost studies.

137. Billings are rendered to affiliates on a monthly basis. All invoices are due and payable within 30 days from the statement date. All late payments are subject to a 1.25% per month late payment charge. Revenue related to the affiliate transactions under review are recorded in Account 5264 Other Incidental Regulated Revenue. These revenues are then prorated to the revenue accounts in each of the five states in the same manner as the expenses that are incurred to provide the service.

138. Several departments within SWBT are involved in the administration of the nontariffed services provided to affiliates. For example, Product Management within the Marketing organization deals with the affiliate, develops cost studies, assesses market prices for similar services, and interfaces with the Legal Department, Contract Administration, and Corporate Books. The Legal Department is responsible for the drafting of the GSAs while Contract Administration is responsible for the monitoring of the service while it is being rendered. Corporate Books renders the bill to the affiliate and records the revenues. The Accounting Classification Group coordinates with all of the above departments and develops methods and procedures for the affiliate transactions under review.

139. In 1992 and 1991, SWBT sold \$5.2 million and \$1.0 million of office furniture and equipment, respectively, to affiliates. The audit team reviewed the supporting documentation for the sale of these assets and concludes that these transactions were accomplished at the higher of net book value or fair market value, in compliance with the affiliate transactions costing standards.

TECHNICAL PERSONNEL SERVICES

140. Technical personnel services include consulting, software support, system analysis, programming, system and application maintenance, documentation, and training. In 1992, the majority of the billed technical personnel services, 96 percent, were provided for the benefit of Southwestern Bell Yellow Pages (SBYP). The service to SBYP was in the form of support for a Bellcore project regarding the Listing Services System (LSS). The portion of the technical personnel services related to the LSS will no longer be provided in 1993, causing an expected decline in billed technical personnel services in the immediate future.

141. The audit team reviewed the contracts and found them to be well documented. Billings appeared adequate. Technical personnel services were priced above FDC. Costs were developed and applied to specific billing units. Technical personnel services, utilized primarily two billing units: labor hours and per month fee for the LSS project support.

DATA PROCESSING SERVICES

142. Data processing services include: scheduling and processing data for affiliate dedicated systems; utilization of the time sharing system; and, production of data on microfiche pages. SWB Yellow Pages incurred over half of the total data processing service billings in 1992. SBC, followed closely by SWB Mobile, were the other major users of this service. A review of the cost data revealed that the prices identified in the pricing addendum to the contracts and billed to the affiliates were above FDC. SWBT performs cost studies and prices the data processing service by the system components utilized. Examples include Central Processor Unit per standard CPU hour used, per page printed, per terminal hour of usage, microfiche per page, labor cost per hour for data center personnel and Virtual CPU time per second for interactive time-share service.

143. In 1993, SWBT began offering the data processing service as a nonregulated service offering. Plans are for the SWBT Intellectual Property Group to manage the provision of the service to outside unrelated third parties in addition to affiliates. The Cost Allocation Manual filed with the FCC will govern the separations of the costs between regulated and nonregulated activities. The affiliate billing system will no longer be used. Revenues from affiliates for the service will not be booked in regulated accounts as the associated expenses are removed from the regulated books.

REAL ESTATE MANAGEMENT

144. Real estate management includes: floor space leasing; furniture leasing; lease administration; architectural planning, design and construction; and, furniture inventory. Approximately 82 percent of the real estate management services in 1992 were

provided to SBC. Technology Resources, Inc. utilized ten percent of the billed services. The largest single component of real estate management services is office space leasing at the One Bell Center location in St. Louis, Missouri. With the relocation of the SBC offices to San Antonio in late 1992, this service will be drastically reduced on a going-forward basis. Lease administration, floor space planning and furniture inventory are all priced above FDC and are charged on an hourly basis. Office space lease service is calculated on a per square foot basis. Furniture rental is priced on a per month basis depending on the item. Billing units are reported to accounting each month. Bills are rendered to the affiliates based on the units and applicable rates.

TEMPORARY SERVICES

145. Temporary services include temporary support to affiliates on a project specific basis. Temporary labor services and certain one-time events, such as the sale of SWBT documents, fall into this category. Over sixty percent of temporary services billed in 1992 were provided to Southwestern Bell International Holdings (SBIH). Labor services for the benefit of Telmex are provided under this schedule under agreement with SBIH. Together, SBIH and SBC accounted for 87% of the total billed temporary services in 1992.

146. The audit team traced the development of over a hundred cost studies and found no major problems in this area. The audit team noted that the price was generally established 25 to 30 percent above FDC. The majority of the cost studies are performed to derive specific labor costs for the provision of services such as those benefiting Telmex through SBIH. Once an employee is identified as providing support to an affiliate, labor costs per hour are prepared for each employee participating in the project. The affiliate is billed an amount equal to the number of hours of labor times a price established above the FDC of the employee's hourly labor rate. SWBT cost studies identify the employee's average labor rate per hour and add both direct and indirect costs based on the work-group averages. Average wage per hour is increased to allow for wage increase, paid absence, premium time, other direct expenses, and directly-assigned items such as secretarial support and next-level supervision. In addition, general supervision and staff and general expense loadings are added to determine fully distributed costs for labor.

147. During the audit, the team noted a number of SWBT managers transferring to SBIH to work with Telmex. In light of the SWBT work force reductions in the past year, the transfers appeared reasonable and regulatory concerns are mitigated.

SOUTHWESTERN ELECTRONIC TANDEN NETWORK (SWETN) SERVICES

148. SWBT provides official communications services to SBC and affiliates on an ongoing basis through the Southwestern Electronic Tandem Network (hereafter referred to as SWETN). SWETN is comprised of facilities owned or leased by SWBT. These facilities include private lines and SWETN System to lines. SWETN serves as the

administrative telecommunications link for SBC, SWBT and affiliates. Services available over SWETN include voice grade services, digital data services (2.4 through 56K bps), wideband digital data services (1.544M bps), and video conferencing at selected facilities. The following table presents information on amounts billed for SWETN service for the years 1989 - 1992, in millions, as compared to the total amounts billed by SWBT to affiliates for all services:

	1989	1990	1991	1992
Amount Billed by SWBT to Affiliates for SWETN Services	\$2.6	\$2.5	\$4.0	\$3.7
Total Amount Billed by SWBT to Affiliates for All Services	25.7	30.1	34.1	38.7
Percentage of Total Amounts Billed by SWBT for SWETN Service	10.1%	8.3%	11.7%	9.6%

149. According to SWBT's Cost Allocation Manual, SWETN services are provided at Fully Distributed Cost (FDC) except for interLATA services which reflect the highest surveyed tariff rates. The audit team reviewed SWBT's policies and General Service Agreements relating to SWETN transactions with affiliates, as well as the development of the message unit cost per minute of use. A comparison of the per minute of use SWETN message service cost derived from the studies and the prices included in the General Services Agreement for SWETN message services indicated that SWETN message services were being priced above FDC.

PUBLIC RELATIONS

150. General public relations services include employee information publications, news clipping service, preparation of graphics, and audio/video tape production. The majority, 91 percent, of billed public relations service was provided to SBC in 1992. SWBT priced the public relations services above FDC for the various services based on the cost components. FDC is developed for each of the SWBT publications based on annual cost per issue for each state. FDC was developed for services such as audio/video services and graphics based on the loaded labor rate per hour of the employees performing the tasks. The SWBT billing is based on the number of hours at the established unit price identified in the contract.

BUSINESS OFFICE SUPPORT SERVICES

151. Business office support is the provision of marketing service and sales on behalf of an affiliate through the SWBT business service centers. Business Office Support is one component of "team marketing" which refers to services involving joint marketing, such as between SWBT and SWB Telecom and between SWBT and SWB Enterprises. SWB Telecom accounted for 54 percent of the 1992 billed services. The remainder, 46 percent, was provided to SWB Enterprises. SWBT essentially receives a sales fee or commission from Telecom for the sale of a Telecom product, such as a key system. SWBT provides the marketing and sales of voice messaging services for SWB Enterprises. SWB Enterprises pays a set fee per successful sale of voice messaging service.

152. During the audit, the audit team noted that team marketing, in the aggregate, is an area of SWBT emphasis and that future growth in the provision of this service is expected. Results in the first part of 1993 show more billings in the first six months of 1993 than in all of 1992. In reviewing business office support services, the audit team noted that some time and motion studies were based on a very small number of observations. The time and motion studies are key to determining the amount of time a service representative spends in the completion of a sale for an affiliate. The time for a successful sale is applied to the hourly labor rate of the SWBT business service representative to determine the cost per unit for the provision of the service. SWBT establishes its price based on the FDC calculations.

Conclusion

153. Based on the audit work performed, nothing came to the attention of the audit team that would indicate that SWBT's nonaffiliated 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. SWBT services rendered to affiliates can be regarded as in a constant state of evolution in response to regulatory interest and emphasis. Procedures are modified and formalized. Services evolve into nonregulated offerings as nonaffiliated, third-party customers are found and market conditions allow. SWBT is reacting in response to the federal and state regulatory interest; therefore, monitoring must continue.

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21 Financial Research/Market Analysis
61 Cash Management
68 Financing Projects

Average Employee Factor

26 Pension Asset Administration
27 Savings Plan Administration
28 Employee Training and Development
29 Compensation Planning and Administration
30 Benefits Planning and Development
31 Human Resources Planning and Staffing
32 Employee Information
71 Corporate Services - Food Services
72 Corporate Services - Automotive
77 Senior Management Benefits Payments

General Factor

- 35 Executive Support
- 36 Office of the Chairman
- 37 Board of Directors
- 38 Tax Counsel, Advice, Planning and Research
- 39 Tax Return Preparation
- 40 Corporate Accounting Research
- 41 Corporate Financial Analysis
- 42 Corporate Books and Reports
- 43 Corporate Budgets
- 45 State Regulatory Activities
- 46 Senior Management Salary and Benefit Administration
- 48 Corporate Record Filing
- 49 Corporate Risk Management
- 50 News and Public Information
- 51 Trademarks, Patents and Graphics Services
- 52 Public Issues Research
- 53 Legislative Advocacy
- 54 Federal Regulatory Activities
- 55 PAC Program
- 56 Corporate Policy Development
- 60 Memberships
- 62 Foundation
- 69 Litigation

Internal Audit Factor

- 70 Internal Audit Services

Marketing Factor

- 80 Corporate Advertising
- 81 Marketing Support

Note: There are occasions when the expenses contained within a cost center may be allocated or directly charged to a particular entity. Therefore, these cost centers will appear on both the direct charged cost centers list and one of the allocated cost centers lists. Other cost centers may be allocated in part, and also retained in part. These cost centers will also appear on both lists.

SBC Charging Directions

Code

- 00 Allocate to All Operating Subsidiaries
- 01 Direct to Southwestern Bell Telephone Company
- 03 Direct to Southwestern Bell Telecommunications, Inc. (Telecom)
- 04 Direct to Southwestern Bell Mobile Systems, Inc. (SBMS)
- 05 Direct to SBC Asset Management, Inc. (AMI)
- 06 Direct to SBC-Washington, Inc. (WASH)
- 07 Direct to SBC Corporate Services, Inc. (CSI)
- 08 Direct to Southwestern Bell Capital Corporation (CAP CORP)
- 09 Direct to Metromedia Paging Services, Inc. (Metromedia)
- 11 Direct to Gulf Printing Company (Gulf)
- 12 Direct to SBC Administrative Services, Inc. (ASI)
- 13 Direct to SBC Technology Resources, Inc. (TRI)
- 15 Direct to Southwestern Bell International Holdings Corporation (SBIH)
- 17 Direct to Gateway Rivers Insurance Company (Gateway)
- 18 Direct to SBC Audit Services, Inc. (Audit)
- 19 Direct to Mast Advertising and Publishing, Inc. (Mast)
- 20 Direct to Southwestern Bell yellow Pages, Inc. (SBYP)
- 21 Direct to Southwestern Bell Enterprises, Inc. (SBE)
- 40 Direct to SWBT-Arkansas
- 41 Direct to SWBT-Kansas
- 42 Direct to SWBT-Missouri
- 43 Direct to SWBT-Oklahoma
- 44 Direct to SWBT-Texas
- 50 Retain in Parent
- 62 Direct to Southwestern Bell International - Oyster Cable (Oyster)
- 63 Direct to Southwestern Bell International - West Midlands (Midland)
- 71 Direct to Southwestern Bell Enterprises - Voice Messaging Services, Inc. (VMS)

SOUTHWESTERN BELL TELEPHONE COMPANY'S ANALYSIS

OF

THE FCC/STATE JOINT AUDIT REPORT

ON

AFFILIATE TRANSACTIONS

February 21, 1994

Executive Summary

SWBT believes that its affiliate transactions are in full compliance with the FCC's affiliate transaction rules and notes that the Audit Report, for the most part, supports this belief. The audit team, after conducting an initial survey audit of all SWBT affiliate transactions, focused on six specific areas of transactions. The criteria used in selecting the six areas were materiality (large dollar amounts) and areas where the potential for cross subsidies exist. The audit team notes that the six areas selected for the more focused audit enabled 100% of the services rendered by SWBT to affiliates and approximately 70% of the services rendered by affiliates to SWBT to be examined by the joint audit team.

In four of the six areas chosen the audit team found there was nothing to indicate that the transactions were not accounted for in a manner consistent with the applicable FCC affiliate transaction standards. SWBT views this language as positive and accurate.

The audit team however concluded that certain allocations from SBC to SWBT and certain transactions with AMI were, in their opinion, inconsistent with the FCC's affiliate transaction rules.

In several areas the audit team's adverse conclusions are incorrect. The audit team has not reasonably interpreted the FCC rules or fairly examined the issues. For example, the audit team:

- A. Changed the Stated Audit Standard Without Notice in Order to Arrive at an Adverse Finding - The stated audit scope was compliance with the FCC affiliate transaction rules. However, the audit team criticizes the relocation of SBC's corporate headquarters, based not on any failure to comply with the affiliate transaction rules, but rather on an alleged failure to meet a prudence of expense standard. The audit team states it deems that SBC has failed to provide "adequate justification for these costs to be allowable and recoverable from the telephone ratepayers". SWBT was not aware that it was expected to meet a ratemaking standard until it received the Audit Report. The audit team does not have an adequate basis to make such a finding.
- B. Ignored Relevant Information in Making Adverse Findings - In an attempt to legitimize a finding of no supporting time reporting documentation, the audit team ignores a wealth of information and documentation provided regarding time reporting, including information provided through personal interviews with 43 employees.

The audit team claims that the lack of survey time studies at SBC hindered their ability to verify SBC time reporting. SWBT notes that the survey time studies are an insignificant element of SBC time reporting, and used

for the sole purpose of evaluating positions whose responsibilities have changed. More integral to the entire time reporting system are the FASC Information Cards which each employee signs each year verifying their time charges. Once this happens, prior time records are inconsequential.

An inordinate amount of information was provided to the audit team to verify time charges at SBC - payroll records, job descriptions, charging directions, interviews with 43 employees, etc.. The audit team surprisingly ignores all of this relevant information and mistakenly argues that the survey time study was the hinge-pin of the entire system. This is not correct or reasonable.

- C. Reaches Erroneous Results - The audit team reaches a result whereby SWBT, the largest SBC subsidiary, would receive a zero cost allocation from the parent for image advertising which clearly benefits SWBT. The audit team also adjusted the SBC general allocator to include retained expenses that are not assigned or allocated. The effect is to substantially distort SWBT's fair share of, and primary role in, continuing the need for such costs. SWBT maintains that the audit team has misapplied the affiliate transactions rules, resulting in an allocation that could not stand a test of reasonableness.

In an effort to verify lease charges to SWBT from ANI, the audit team averaged the lease payments of non-affiliates. SWBT was not aware this was an acceptable methodology for determining prevailing price.

- D. Miscalculates and Overstates Computations - The computations of the effects of the findings are flawed. For example, the audit team determined that its finding regarding the general allocator was worth a total reduction in the allocation to SWBT of \$62.5 million over four years. SWBT's computation, based on the audit team's philosophy, resulted in a reduction of that allocation to only \$37.6 million. Finally, the audit team calculated the amount over a four-year period. Though this resulted in a large number, it is more common to determine the financial impact of an issue over one year. Even based on their erroneous computation, the 1992 amount is only \$22.3 million.

SWBT emphasizes that it does view the audit report as largely positive, and that the audit report confirms that SWBT is, for the most part, in compliance with the FSC's affiliate transaction rules. However, SWBT takes strong exception to those areas where the audit team has claimed we are not in compliance with the rules. We exhibit the following in analysis of the audit report.

February 21, 1994

**Southwestern Bell Telephone Company's Analysis of the Report
of the Joint Audit Team**

This letter is Southwestern Bell Telephone Company's response to the "Five States Regulatory Commissions and Federal Communications Commission Joint Audit Team Report" on its "Review of Affiliate Transactions at Southwestern Bell Telephone Company," dated February 9, 1994 ("Audit Report"). As detailed in the Proprietary Agreement, the Joint Audit was voluntarily agreed to by SWBT with the understanding that the audit was to determine SWBT's compliance with the Federal Communication Commission's (FCC) affiliate transaction rules as promulgated in FCC CC Docket 86-111, commonly known as the Joint Cost Proceeding, and set forth in 47 CFR 32.27 and 47 CFR 64.901. The Audit Report reiterates that the objective of the audit was to determine compliance with the FCC's affiliate transaction standards.

SWBT believes that its affiliate transactions are in full compliance with the FCC's affiliate transaction rules and notes that the Audit Report, for the most part, supports this belief. The audit team, after conducting an initial survey audit of all SWBT affiliate transactions, focused on six specific areas of transactions. The criteria used in selecting the six areas were

¹ Proprietary Agreement-Attachment A Audit Scope; Bruno Letters of April 22, 1993 & May 12, 1993, Joint Audit Report, para. 32. The six areas chosen for a more focused audit were:

1. The allocation of costs from SWBT's parent corporation, Southwestern Bell Corporation, to SWBT.
2. SWBT's purchase of service and leasing of space from Southwestern Bell Asset Management, Inc. (AMI). AMI provides a variety of real estate related services.
3. SWBT's purchase of products and services from Southwestern Bell Telecommunications, Inc. (SWB Telecom). SWB Telecom markets customer premises equipment and related services.
4. SWBT's purchase of research and other related services from Southwestern Bell Technology Resources, Inc. (TRI).

materiality (large dollar amounts) and areas where the potential for cross subsidies exist. The audit team notes that the six areas selected for the more focused audit enabled 100% of the services rendered by SWBT to affiliates and approximately 70% of the services rendered by affiliates to SWBT to be examined by the joint audit team.

In four of the six areas chosen the audit team found there was nothing to indicate that the transactions were not accounted for in a manner consistent with the applicable FCC affiliate transaction standards. The audit team however concluded that certain allocations from SBC to SWBT and certain transactions with AMI were, in their opinion, inconsistent with the FCC's affiliate transaction rules.

In several areas the audit team's adverse conclusions are incorrect. The audit team has not reasonably interpreted the FCC rules or fairly examined the issues. For example, the audit team:

- A. Changed the Stated Audit Standard Without Notice in Order to Arrive at an Adverse Finding - The stated audit scope was compliance with the FCC affiliate transaction rules. However, the audit team criticizes the relocation of SBC's corporate headquarters, based not on any failure to comply with the affiliate transaction rules, but rather on an alleged failure to meet a prudence of expense standard. The audit team states it deems that SBC has failed to provide "adequate justification for these costs to be allowable and recoverable from the telephone ratepayers". SWBT was not aware that it was expected to meet a ratemaking standard until it received the Audit Report. The audit team does not have an adequate basis to make such a finding.
- B. Ignores Relevant Information in Making Adverse Findings - In an attempt to legitimize a finding of no supporting time reporting documentation, the audit team ignores a wealth of information and documentation provided

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- 5. SWBT's purchase of cellular phones and cellular service from Southwestern Bell Mobile Systems, Inc. (SWMS).
 - 6. SWBT's sale of nonratified assets and services to affiliates.

² The four areas were SWBT sales of assets and services to affiliates; SWBT purchases of services from TBI; SWBT purchases of assets and services from SWB Telecom; and SWBT purchases of assets and services from SWB Mobile Systems.

regarding time reporting, including information provided through personal interviews with 43 employees.

- C. Reaches Erroneous Results - The audit team reaches a result whereby SWBT, the largest SBC subsidiary, would receive a zero cost allocation from the parent for image advertising which clearly benefits SWBT. The audit team also adjusted the SBC general allocator to include retained expenses that are not assigned or allocated. The effect is to substantially distort SWBT's fair share of, and primary role in, continuing the need for such costs.
- D. Miscalculates and Overstates Computations - Not only are the audit team's findings incorrect, and not consistent in the application of the affiliate transaction rules, but the computations of the effects of those findings are also flawed. For example, the audit team determined that its finding regarding the general allocator was worth a total reduction in the allocation to SWBT of \$62.5 million over four years. SWBT's computation, based on the audit team's philosophy, resulted in a reduction of that allocation to only \$37.6 million. Finally, the audit team calculated the amount over a four-year period. Though this resulted in a large number, it is more common to determine the financial impact of an issue over one year. Even based on their erroneous computation, the 1992 amount is only \$22.2 million.

In this response, SWBT will explain the errors in the audit team's interpretations and demonstrate that the allocations and transactions called into question were in fact booked consistent with the affiliate transaction standards. SWBT will also note instances where, even assuming as correct the audit team's interpretations of the affiliate transaction rules, the amount of money cited by the audit team is incorrect.

ALLOCATION OF COSTS FROM SBC TO SWBT

SWBT disagrees with the audit team's treatment of allocations from SBC, SWBT's parent corporation. The Audit Report makes three specific findings regarding costs flowing from SBC to SWBT: 1) SBC

SWBT will confine its response to those transactions which were within the above referenced scope of the audit or were directly called into question. Thus, SWBT will ignore the inclusion in the report of unrelated topics such as recent acquisitions and ventures by SBC or the trialing of PCS technologies.

has no supporting documentation for time charging by its employees, 2) SBC is using an improper marketing allocator, and 3) SBC is using an improper general allocator. Each finding is unsupported by the facts. SWBT will address each item separately and then address the audit team's expansion of the audit scope.

Documentation for Time Charging

The joint audit team's claim that there was "no supporting documentation for time charging by SBC's employees" and thus it "could not determine the reasonableness of SBC's expenses charged to SWBT" is simply untrue. The audit team has created an issue where none exists.

The "no supporting" documentation referred to is in reality a single type of document called a "survey time study". It is one very small part of the entire time reporting system. SBC's internal procedures state that a four-week survey time study should be performed for new positions that are created or for existing positions that change substantially. The audit team requested the 1992 survey time studies during the audit. SWBT explained that the individual judgment of each manager determines whether this type of study is conducted and how often. The reason for leaving the decision to the manager's discretion is obvious--the manager on the job is in the best position to know if the job is changing. SWBT also explained that the internal procedures did not provide for the studies to be centrally retained or retained for a definite period and thus to obtain the 1992 studies would require a manual search of all positions within SBC. The auditor was also informed that it was SBC's belief that very few time studies were performed in 1992, given that there were very few, if any, new jobs created or responsibility changes in existing positions. Nevertheless, the audit team has focused on the survey time studies to create the impression unfairly that there is a lack of documentation supporting the allocations in an attempt to cast doubt on the entire corporate time reporting system.

⁴ Further, SWBT told the auditors that, after the recent move to San Antonio, the few 1992 time studies that the SBC Accounting Department did receive, could no longer be located. SBC did provide to the audit team new time studies that had been conducted after the move to San Antonio. In fact, time studies were supplied for two entire departments who restudied their time after job responsibilities were shifted within their organizations. Though the time studies were for 1993, and thus claimed by the audit team to be outside the audit period, they nonetheless demonstrate that SBC's internal procedures are working and that time studies are prepared as needed. Furthermore, SBC did provide one 1992 time study to the audit team.

The audit team's portrayal of the survey time study as the key to the whole allocation system is erroneous. Contrary to the audit team's claim, the cost allocation system is not "for the most part . . . driven by survey time studies". It is driven by accurate reporting of time. Although survey time studies represent one tool used to verify time reporting when a position substantially changes, they are not the sole method of determining proper time allocations and are insignificant if job functions stay constant. As was discussed with the auditors and as explained below, SBC uses several methods or tools to determine proper time allocations. Documentation regarding these methods was available to the auditors.

As was explained to the audit team, SBC has very specific procedures for assuring accurate time reporting. The job description itself in most cases is sufficient to indicate the allocation. The audit team was also made aware that each year during the March/April time frame, each SBC employee receives a report (called a FASC Information Card) which shows the charging direction of that particular employee. The employee verifies the charging direction or notes any changes, signs the report, and returns it to SBC Corporate Accounting. Corporate Accounting then performs a reasonableness check based on the job description. The final report is then used to report and allocate the employee's time throughout the year. It was also explained to the audit team that when an employee performs functions outside of their normal job responsibilities, an "exception time report" is prepared whereby the exception time is specifically recognized in the payroll system. The audit team was also told that SBC corporate accounting regularly conducts time reporting training sessions for all employees. The purpose of the training sessions is to remind employees of SBC's cost allocation system requirements, review exception time reporting requirements, review day-to-day time reporting and answer any questions regarding the reviews.

Contrary to the audit team's implication, time studies are not an FCC requirement; rather, they are an internal procedure developed for a specific circumstance - i.e. a significant change in responsibilities. In the Joint Cost Order proceeding the FCC did

³ The fact that time studies are developed pursuant to internal procedures rather than as a result of the FCC's rules, negates the audit team's claim that the failure to retain the survey time report constitutes a violation of Section 32.12(b). Section 32.12 deals with a carrier's, not a parent company's, "financial records" requiring them to be kept in accordance with generally accepted accounting principles and the detail records to be readily accessible to FCC representatives. Applying Section 32.12(b) to impose an unstated requirement for the parent corporation to retain a survey time study

not mandate a set of specific procedures and records to be developed and kept by a carrier's affiliate to determine compliance with the affiliate transaction rules. Rather, the FCC requires that "sufficient documentation" be retained to enable the FCC to assess if affiliate transactions were recorded in compliance with FCC rules. SWBT provided the audit team with a substantial and sufficient amount of documentation including, but not limited to, corporate employee time records, information from the FASC cards, exception time reports, cost center charging directions and 1993 survey time studies, all of which demonstrate compliance with FCC rules. The audit report in fact acknowledges that the audit team reviewed exception time reports, compared descriptions of functions and beneficiaries of those functions to the work actually performed by selected employees, and reviewed written procedures associated with the SBC Cost Allocation System. Thus, the audit team was supplied with sufficient documentation to assess compliance with FCC rules.

If there were any lingering doubts about the accuracy of SBC time reporting, the awareness of the SBC employees, the procedures in place or SBC's dedication to accurate time reporting, it should have been dispelled during the face-to-face interviews the audit team had with randomly-selected SBC employees in San Antonio. The audit team interviewed 43 SBC employees to discuss their individual time reporting. The audit team acknowledges in its report that 100% of the employees interviewed responded in the affirmative that their actual time charging was representative of their work effort.

SBC spent considerable time and resources in complying with the audit team's request to have face-to-face interviews with SBC employees. Thus, SWBT is surprised by the audit team's single conclusion as to these interviews - "although all SBC employees who were interviewed responded in the affirmative that their actual time charging was representative of their work effort, the audit team, nonetheless, had no alternative but to either accept that claim wholly on faith or to reject it." The real problem with this statement is that an auditor can always rely on the excuse that he has no alternative but to accept "wholly on faith or reject" the truthfulness of an assertion, regardless of whether the assertion is made in an interview or supported by a warehouse full of documents created by the interviewee. An auditor obviously does not have personal knowledge of the facts because he was not there and thus he is always obliged to either accept something on faith

which is a record established only pursuant to internal procedures for which there is no retention period is totally void of any semblance of due process. SWBT, by questioning the applicability of 33.12, does not question whether the audit team has a right to review the survey time reports, only the applicability of Section 33.12.

or totally reject it. Further, SWBT provided the audit team with more than enough information, including all the documentation described above, to warrant a finding on more than just "faith". The undeniable fact remains that the records indicated that the employees' time was being charged in a certain manner and the employees confirmed that the charging was representative of their work effort.

After reviewing the Audit Report, SWBT is further concerned about why the interviews were in fact held if they were not going to be used to substantiate accurate time reporting. The audit report states that "43 SBC employees were interviewed in San Antonio, Texas, none of whom could produce the required four week time study on which their current allocations were based." This finding should not have been a shock to the audit team, since the fact that 1992 survey time studies were not available was relayed to the audit team prior to their visit to San Antonio to interview corporate employees. In fact, the audit team gave SWBT the impression that this circumstance required face-to-face interviews with employees to determine time charging given that no studies were available.

The audit team stated in Data Request 4023:

. . .It is our understanding that these time studies are not prepared on a regular or current basis. Instead, employees inherit their cost center and charging direction from their predecessor. Nevertheless, we need some basis for determining if the current allocation of SBC time and associated other charges which is based on these historical time studies is currently accurate and appropriate. This audit step will be performed in San Antonio.

Further, Data Request 4019 stated:

Using a sample of employees provided in DR4018 I would like to interview those employees to test the accuracy of the time reporting aspects of the CAS.

From these data requests, SWBT was given every indication that an audit interview was a viable means of discovery and would be used to judge the accuracy of the charging directions. In fact, SWBT's response to Data Request 4023 stated:

It is SWBT's and SBC's understanding that the purpose of the interviews scheduled with each employee is to verify the accuracy of the records provided to the audit staff in response to data request 4012. [Records in Data request 4012 consisted of time reports, charging directions, etc..]

As the response to Data Request 4023 indicates, SWBT believed that the results of the interviews would be used as substantial evidence of time reporting accuracy. Yet, the audit team now dismisses the responses of SBC employees seemingly because they have "to accept . . . wholly on faith or reject" that the employees were being truthful. The auditors knew that this was the situation before they ever left for San Antonio. If the only purpose of the trip was to obtain an audit finding that a 1992 survey time study was not available for the 43 employees being interviewed, SWBT would have stipulated to the fact and saved everyone's time and money.

SWBT emphatically believes that the time reporting procedures which have been in place and followed at SBC are sufficient. The process is continually reviewed and updated. The audit team notes the continual review with the acknowledgement that the SBC Cost Allocation System manual was revised on 9/23/93. The audit team notes that it received the revised manual, which had been previously discussed with the auditors, on November 15, 1993, after completion of the audit field work. Given the fact that SWBT did not receive a Data Request on this subject, when SWBT continued to receive Data Requests on other subjects until January 31, 1994, and that the revisions were not negatively commented on in this report, SWBT assumes the revisions were adequate.

SWBT is concerned that the audit team seems to presume bad faith and reject or ignore all of the conclusive data provided by the SBC employees during their interviews and the tremendous amount of documentation that was provided to the audit team in support of the corporate time allocations. SWBT is perplexed as to why the audit team appears, without any legitimate explanation, to reject the findings of the interviews, reject the documentation provided and instead chastises SBC because SBC did not follow the audit team's interpretation of what the SBC internal policy regarding survey time reports should be. SWBT is especially troubled by these accusations, given that no specific discrepancy in time reporting ever surfaced.

SBC Marketing Allocator

The audit team contends that SBC's manner of allocating corporate advertising and marketing support expense is inconsistent with the audit team's interpretation of the Joint Cost Order language. SWBT submits that the audit team's interpretation ignores the concept that costs should be assigned on a cost-causative basis.

SBC incurs two types of advertising costs. The first is advertising costs which are subsidiary-specific. SBC directly assigns those costs to the applicable subsidiary. The second type of advertising cost is "image" or "promotional" advertising (hereinafter "image advertising") which is not subsidiary-specific, but benefits all of the operating subsidiaries. The image advertising, unlike the subsidiary specific advertising, cannot be directly assigned. One

method of assigning the image advertising cost would be to allocate the costs to all subsidiaries based on the subsidiaries' relative size. This would be logical given that image advertising presumably benefits all affiliates.

Instead of using a general allocation methodology, SBC chose a more stringent method to better reflect cost causation, consistent with FCC affiliate transaction rules. SBC's cost causative allocation method is based on the advertising dollars spent by each subsidiary, including advertising dollars spent on SBC subsidiary-specific advertising, as an indication of the importance of advertising to that line of business. SWBT believes this method is a reasonable and fully supportable basis for allocating image advertising.

The audit team contends that "image advertising" costs should be allocated based solely on SBC-incurred "subsidiary-specific advertising costs". The audit team's entire argument is premised on a quote from the Joint Cost Order that ". . . all costs that can be apportioned on the basis of direct assignment or cost causational to be so apportioned. Residual marketing expenses will be divided between regulated and nonregulated activities based on the ratio of directly assigned and attributable costs." The fallacy of the audit team's interpretation is that image advertising costs are not residual costs. Image advertising costs represent a separate form of advertising which is allocated on a cost causational basis. SBC's use of this cost causative-based type of allocator is no different than the use of other accepted allocations (investment, employment) which use a cost causative measure for allocating costs.

Following the audit team's interpretation could lead to distortion of the process. A parent could allocate 100% of all expenses from image advertising to the telephone company merely by performing subsidiary specific advertising only for the telephone company. In that scenario, the other operating subsidiaries, merely by choosing a third party to perform subsidiary-specific advertising, would benefit from the image advertising without an allocation for the expense. Such an absurd result is demonstrated in the Audit Report itself. The Audit Report suggests that SWBT, the largest subsidiary who presumably derives a benefit from image advertising, should have had an allocation of zero for image advertising costs, merely because it did not purchase subsidiary specific advertising from SBC.

The allocation method used for image advertising costs is the most appropriate, as it is based on cost causation and avoids the absurd result that could be suggested by the audit team's interpretation.

In addition, the audit team asserts that there are prior year credits to direct costs in Cost Center 001 that did not accrue to SWBT. Specifically, the audit report contends that the numbers

indicate that "in 1992 SWBT received a refund of prior years direct charges for Corporate Advertising and Marketing Support combined." This is incorrect. In 1991, SBC booked an accrual for certain advertising/promotion expenses as a direct charge to SWBT in Cost Center 081. In 1992, SBC reversed that accrual in Cost Center 081 and booked the actual expense payments in Cost Center 081. The impact of both transactions were included in the computation of the Marketing Allocation Factor used for Cost Centers 080 and 081. Given the common accounting treatment of accruing for an expense in one period and reversing in another, SWBT assumes that the audit team simply misunderstood this issue.

SBC General Allocator

The audit report takes the position that SBC's retained expenses should be included in the calculation of the general allocator. This argument is incorrect and unsupported.

The audit report suggests a major and unnoticed change in the FCC rule on the calculation of a general allocator. The general allocator is to be calculated under the rules based upon expenses that are directly assigned or attributed. Retained expenses are not assigned or attributed to the operating subsidiaries, and therefore should not be used in determining their share of the generally allocated costs. To pretend, as suggested by the audit team, that retained expenses are assigned or attributed to stockholders is to create a regulatory fiction which is wholly unsupported. Stockholders are not billed for expenses, they are paid dividends. The interpretation is also contrary to the common dictionary definition of retain which is "to keep or hold in one's possession". Expenses which are kept or held are not, in the cost allocation process, assigned or attributed.

Including retained expenses in the calculation of the general allocator also introduces a number of illogical and unexplained inconsistencies into the allocation process. First, it results in expenses being excluded for one purpose (retention), but included for another purpose (allocation). Second, it results in costs that are not assigned or allocated to subsidiaries being used to determine how costs are allocated to those subsidiaries. Third, it produces absurd results that have no logical relationship to cost causation or any other reasonable measure of responsibility for the underlying costs.

The latter point is documented by and illustrated in the express findings of the audit report. Inclusion of retained expenses in the calculation of the general allocator reduces SWBT's share of the SBC generally allocated costs from 69% to 43%. This reduction is unreasonable on its face considering that SWBT represents 75% of the SBC investment, 84% of its employees, and 77% of its revenues. Obviously, SWBT is responsible under any reasonable interpretation for a much greater portion (more than 43%) of SBC's general

expenses and generally allocated costs. That is, the audit report flatly ignores SWBT's primary responsibility for the creation and incurrence of these costs, and results in their being allocated on an irrational and non-cost causative basis.

The proposal on including SBC-retained expenses in the calculation of the general allocator simply does not make sense. It is not only contrary to the FCC's current rules, it is illogical, inconsistent, and likely to do more harm than good. Suffice to say, SBC is conservative in its retention of costs. SBC's retention of costs policy did not envision piling on additional costs unrelated to the purpose of retention. Such a policy would likely force SBC to reevaluate its conservative retention policy.

Finally, SWBT does not agree with the dollar effect of the audit team's finding regarding the general allocator. SWBT's recomputation, based on the audit report's proposed methodology, results in only a \$37.6 million total reduction of allocated cost to SWBT for 1989 through 1992 versus the \$62.2 million noted in the audit report. The audit team apparently did not consider all of the intricate calculations involved in such a redistribution and apparently only made a "rough estimate" of the difference.

SBC Corporate Relocation Costs

With the receipt of the Audit Report SWBT learned that the audit team had expanded the audit scope and standard to include justification of the move of SBC's corporate headquarters from St. Louis, Missouri, to San Antonio, Texas. The Audit Report unequivocally states that the objective of the audit was to determine compliance with the affiliate transaction standards and ensure that telephone customers had not been adversely affected by potential cross subsidies flowing to non-regulated affiliates as a result of any noncompliance with these standards. The purported finding regarding relocation has nothing to do with this objective. In fact, the audit team makes no finding regarding the recording of the transaction on SWBT's books. The audit team does admit, though, that the issue is "unrelated to compliance with the affiliate transaction rules" and thus beyond the scope of the audit. Whatever purpose the discussion is meant to serve, it has no purpose in this Audit Report. SWBT submits that the audit team has no basis for its purported finding and no legitimate reason for inclusion of this "retemaking" issue in an affiliate transaction audit. Polluting this audit by purporting to make such a "finding"

⁶ Yet, the audit report itself lists several legitimate reasons that support the decision to relocate the SBC headquarters, not the least of which is that 60% of the "core" SWBT business is in Texas.

will inevitably have a chilling effect on SWBT volunteering to participate in such audits in the future.

TRANSACTIONS FROM AMI TO SOUTHWESTERN BELL TELEPHONE COMPANY

Office Space

The audit team contends that SWBT recorded charges for office space from AMI at more than prevailing market price. The audit team presumes that a prevailing price can be established by averaging the price per square foot for nonaffiliated third parties in the building and then determining whether SWBT paid more than the average. The audit team's method for calculating prevailing price is inconsistent with SWBT's understanding of past Commission direction, in the Joint Cost Order proceeding and various Common Carrier Bureau orders, regarding establishing prevailing price. SWBT's understanding was that a prevailing price could not be established by merely averaging the prices paid by unaffiliated third parties.

The nonaffiliated tenants in the buildings in question were paying a variety of differing rates. At the Pinehollow location, there were 23 non-affiliated tenants paying 15 different rates per square foot with a \$4.75 difference between the high and low rate. At the Centerpoint location, there were 9 nonaffiliated tenants paying 9 different rates per square foot with a \$3.01 difference between the high and low rate. Differing prices in a building is not uncommon as a variety of factors including location, view, access, parking, length of lease, space required and build-out will influence the cost per square foot in the same building.

The lease rate paid by SWBT at both locations included the cost of additional build outs (i.e., interior walls, special fixtures) that were not required by other tenants. SWBT chose to amortize the additional build out costs over the lease rather than making one payment. Section V of the leases, provided as a supplemental response to Data Request 7b, notes that the base lease rates for the two locations were Pinehollow-\$11.60 per square foot and Centerpoint-\$11.00 per square foot. The fully distributed cost studies performed on both locations confirm the fully distributed cost of the base rate and the build outs. The base rate paid (i.e., lease rate minus the build outs) is comparable to the lease rates paid by other similarly situated nonaffiliated tenants. SWBT believes that the lease rates paid at both locations are consistent with affiliate transaction rules.

Hotel Majestic Issues

AMI has an ownership interest in the Hotel Majestic, a downtown St. Louis hotel which is directly across the street from One Bell Center, SWBT's corporate headquarters; and the downtown St. Louis

Southwestern Bell complex.⁷ SWBT's parent company, SBC, has a contract whereby a set number of rooms are reserved at a set rate. The number of rooms vary depending on whether a week-day or weekend is involved and various other factors. The contract assures that lodging will be available and available at a reasonable price regardless of occurrence of activities in downtown St. Louis which cause hotel occupancy rates and thus hotel room rates to rise. Such activities include conventions, sports activities such as the World Series and weekend series with geographical rivals such as the Chicago Cubs and vacation season traffic. In exchange for the very favorable set price and reserved block of rooms 365 days a year, unoccupied rooms in the reserved block are also billed. SWBT is the beneficiary of the guaranteed reserved block of rooms available and thus pays for any unoccupied rooms.

The audit team notes a perceived problem with the room rate differential process. The room rate differential process was an internal process whereby reservations made through SWBT Travel Services received a quoted rate cheaper than the contract rate. The guest would be billed the cheaper rate at check-out and the difference between the cheaper rate and the contract rate would be charged to Travel Services. As was explained to the audit team, the differential policy was offered to encourage use of the Hotel Majestic, for which SWBT has a very favorable contracted room rate, in comparison with comparable hotels in downtown St. Louis. As was further explained to the audit team, the process was being phased out when the audit began. Travel Services began the phase out in April 1993 by lowering the amount of the differential and discontinued it altogether in September of 1993. After discontinuance, SWBT Travel Services manually calculated the amount of differentials paid on behalf of non-SWBT employees and received payment from SBC for that amount. Thus, the audit team's concern about the amount of room rate differentials paid by SWBT has already been addressed.

The audit team also contends that, while it takes no exception to the contracted room rate paid during the week, it concludes that the ~~same~~ contracted room rate is not in compliance with the affiliate transaction rules if paid on the week-end. The audit team's conclusion is based on its acceptance of a prevailing market price of \$49 for the week-end rates. Thus, the audit team ignores the fact that the contract sets forth ~~gag~~ set room rate. SWBT submits that the contracted rate is consistent with the affiliate transaction rules because a comparable prevailing price

⁷ The Southwestern Bell complex in downtown St. Louis covers a contiguous four block area which includes One Bell Center, 1010 Pine (which houses various SWBT headquarter departments), SWBT's Data Center and 100 N. Tucker which is the headquarters of SWBT's Missouri operations.

cannot be established for the rooms and thus the cost is based on fully distributed cost. This fact is documented in SWBT's cost allocation manual and the fully distributed cost studies provided to the audit team. SWBT's position has been consistently based on its understanding of the Commission's interpretation of the affiliate transaction rules that a prevailing price for rooms at the Hotel Majestic could not be established because of the unique contractual relationship (reserved rooms and a set guaranteed rate) and the fact that the price that a hotel, including the Hotel Majestic, charges for a room will vary greatly from night to night depending on its anticipated occupancy rate. Thus, as explained to the audit team in the supplemental response to Data Request 3060, the weekend rate for others is not guaranteed and can be suspended at any time, including when the anticipated occupancy rate is high or even discontinued altogether. The special weekend rate available to others simply is not a guaranteed rate or even a guarantee that a room will be available as is the contracted rate. To claim that a special limited availability week-end rate should be used to establish a prevailing price for a guaranteed availability 365 day a year set rate is not only inconsistent with the affiliate transaction rules, it is fundamentally unfair. SWBT believes that the contracted rate is consistent with the affiliate transaction rules, as the audit team acknowledges, and submits that the consistency does not change when the contracted rate is paid on the weekend.

Finally, the audit team contends that the Hotel Majestic is not in compliance with SWBT internal operating procedures because the invoices did not include "cost information" related to prevailing market price or fully distributed cost on the invoices it provided to SWBT. The audit team states that it deems this information essential for SWBT "to comply with internal operating procedures, and for SWBT to properly record charges in its regulated accounts." SWBT submits this is not necessary. The invoices referred to are the charge slips one normally receives when checking out of a hotel. As noted in the Cost Allocation Manual, all room charges are based on fully distributed cost with other charges such as food and beverage being charged at prevailing price. The room rate is set pursuant to contract. Fully distributed cost studies have been performed to substantiate, and have substantiated, that the room charge is below fully distributed cost. SWBT fails to understand why the failure to note the cost information on the individual invoices "is essential" for SWBT and submits that such an activity is simply a redundant exercise.

AMI Home Relocation Services

AMI provides home relocation services to employees of SAC companies, including assistance in selling a transferee's home. The booking of the services are based on a fully distributed cost methodology.

The audit team had a potential concern regarding the manner in which fully distributed cost was calculated in 1992; however, it did not deem the amount material. The concern appears to be the result of a misunderstanding regarding the development of the general allocator at AMI. In paragraph 75a of the Audit Report, a question is raised regarding the use of cost of goods sold in the development of the general allocator. The Audit Report incorrectly concludes that this computation somehow uses home inventories to develop the factor. Home inventories are not part of the computation of the general allocator. The general allocator is based on the ratio of expense (directly reported and assigned) for each line of business to the total expenses (directly reported and assigned) for each line of business. Thus, home inventory is not part of this computation. This is fully consistent with the requirements of the FCC rules as articulated in the Order and Reconsideration, CC Docket 86-111, Released October 16, 1987, which said that "Other costs, such as those incurred to obtain the inventory, manage it, or dispose of it, are ordinary operating expenses that should be included in the general allocator."

Also, the audit team contends that the fact that the Home Relocation Contract was signed by SBC is contrary to the audit team's interpretation of SWBT's internal Schedule of Authorizations. The contract is not at odds with SWBT's interpretation of SWBT's internal policies. The home relocation contract is a corporate contract applicable to all affiliates, and as such was signed by the CEO of the Corporation. Any further authorization was not necessary. SWBT does not perceive any internal control weaknesses.

CONCLUSION

As the above indicates, SWBT believes that its affiliate transactions are in compliance with the FCC's affiliate transaction rules and the Commission's past interpretations of those rules. SWBT, SBC and the other SBC subsidiaries view compliance with the affiliate transaction rules as a very serious matter. SWBT's conservative application of the FCC affiliate transaction rules is evidenced by the fact that for the sale of services by SWBT to affiliated companies from 1989 through 1992, SWBT recorded approximately \$25 Million in revenues ~~above~~ SWBT's fully distributed cost to provide the service. This is far beyond the requirements of the existing rules. In addition, in 1992 (and similarly in prior years), those services that SWBT purchased from affiliated companies that were subject to the fully distributed cost provision of the FCC rules, were provided to SWBT at approximately \$1.4 Million ~~below~~ the affiliates' fully distributed cost. As such, the regulated customer received a substantial benefit as a result of SWBT's affiliate transaction policies.

JOINT AUDIT TEAM'S REPLY COMMENTS TO

SOUTHWESTERN BELL TELEPHONE COMPANY'S ANALYSIS OF

THE FCC/STATE JOINT AUDIT REPORT ON

AFFILIATE TRANSACTIONS

EXECUTIVE SUMMARY

The audit team has reviewed SWBT's comments and continues to fully support its findings and conclusions contained in the joint audit report on its review of affiliate transactions at SWBT. The audit team believes that it was fair and objective in reaching its conclusions. This is evident by the facts presented in the joint audit report, which clearly demonstrate when the affiliate transactions with SWBT were in compliance with the affiliate transactions standards and when they were not. Based on the conduct of this audit, there is no indication that the concerns initially expressed about joint audits by SWBT have materialized. Therefore, future joint audits should be encouraged.

SWBT claims that in several areas, the audit team's adverse conclusions are incorrect and that the audit team has unreasonably interpreted the FCC rules or unfairly examined the issues. The audit team takes exception to all SWBT allegations. Silence regarding any SWBT assertion should not be construed as acceptance.

A. The Audit Team Did Not Change the Stated Audit Standard Without Notice in Order to Arrive at an Adverse Finding as Charged by SWBT

The scope of this audit, agreed to by both SWBT and the audit team, clearly allows for audit effort that goes further than the six stated areas reviewed by the joint audit team. Regardless of this fact, the charge to SWBT by SBC for relocating SBC's corporate offices from St. Louis, Missouri to San Antonio, Texas is clearly an affiliate transaction. The audit team was neither critical nor treated this charge as a finding, contrary to SWBT's comments on this issue. The audit team merely presented the facts as the audit team saw them. To imply that this work was done merely to generate an adverse finding is both incorrect and totally unsupported by the facts.

B. The Audit Team Did Not Ignore Relevant Information in Making Adverse Findings

SWBT claims the audit team ignored a wealth of information and documentation regarding time reporting at SBC. The audit team considered and examined all documentation provided by the company. It even employed alternative audit procedures in order to determine whether the computation of the cost allocators derived from time reporting could somehow be verified. The company could not produce either the time studies used for the computation of these cost allocators or any sort of contemporaneous time record. According to the company, the audit team had to merely accept the employees' verbal statements that the time allocators were correct without any sort of

corroborative evidence. SWBT knows, or should know, the type of evidence that the auditors were seeking, but it did not provide such documentation.

SWBT notes "that the survey time studies are an insignificant element of SBC time reporting, and used for the sole purpose of evaluating positions whose responsibilities have changed." The audit team strongly disagrees with this statement and believes that time reporting is a significant element for allocating SBC's costs to its subsidiaries. SBC performs labor intensive functions which could only be allocated by accurate time reporting. The absence of support for accurate time reporting could put in question all costs allocated by SBC. The audit team finds SWBT's position contradictory to SBC's newly revised CAS Users' Guide wherein SBC establishes the following requirement: "Each employee will be required to provide the support used in determining their Cost Center Number (CCN) assignments and percentages. Managers may want to consider conducting annual time studies which would be a strong means of support for CCN assignments." This revision supports the audit team's conclusion.

C. The Audit Team Did Not Reach Erroneous Results

SWBT implies that, because it is the largest subsidiary of SBC, it must benefit from image advertising, presumably, in direct proportion to its relative size. The audit team was not provided with documentation to support such claim. Furthermore, the audit team strongly disagrees that image advertising benefits primarily the telephone company. On the contrary, the audit team believes that SWBT affiliates would be the primary beneficiaries of image advertising by association with SWBT, the company which has the established reputation and which has been in existence for the longest time.

The audit team questioned the formula used to allocate SBC's marketing costs since it is based on a combination of SBC directly-incurred marketing costs and subsidiary directly-incurred marketing costs. This practice is clearly not in conformance with the affiliate transactions costing standards, which provide that only the allocating company's incurred costs be included in the formula. This SBC self-designed formula effects a disproportionate assignment of marketing costs to SWBT. Contrary to SWBT's position, the audit team believes that SWBT has misapplied the affiliate transactions rules.

The audit team disagrees with SWBT's assertion that the costs retained by SBC should be excluded from the calculation of the general allocator. The audit team's conclusion on this issue is based upon an appropriate identification of the beneficiaries of SBC's services. It is indisputable that the benefits of certain SBC activities do not accrue to any subsidiaries, including SWBT. These activities would include, among other things, costs associated with merger and acquisition opportunities and new venture start-ups. SBC appropriately retains these costs, since these services are of benefit to its

stockholders. In effect, SBC is direct charging such costs to itself. Therefore, these SBC direct charges should be treated no differently than direct charges to SWBT or any other subsidiary for purposes of allocating residual costs. The audit team stands firm on this issue and inclusion of these costs in the computation of the general allocator is appropriate.

In reference to the issues related to transactions with AMI, SWBT is apparently in agreement with the audit team's findings on the inappropriate practice of charging room rate differentials at the Hotel Majestic to SWBT, since it discontinued this practice in September of 1993, after the audit team brought this matter to the attention of the company. However, the audit team is concerned that the Home Relocation Services Agreement does not require authorization by SWBT's officials, since SBC authorized this contract. The audit team considers this to be a serious matter having the potential of committing SWBT to contractual agreements with any of its affiliates without SWBT's authorization. Finally, SWBT confuses the facts when it addresses the development of the general allocator at AMI, instead of addressing the apportioning of rate base items to separate lines of business.

D. The Audit Team Did Not Miscalculate and Overstate Computations

The audit team's computations of the effects of the findings are not flawed. In disagreeing with the audit team's calculated amounts for the general allocator, SWBT confuses rather than clarifies the situation. The audit report, for example, shows the calculation both by year and in total for the four-year period. The audit team considers this presentation neither unusual nor erroneous. The total amount shown in the audit report is \$62.2 million, rather than the \$62.5 million in SWBT's comments.

SWBT claims that "[e]ven based on their erroneous computation, the 1992 amount is only \$22.2 million." Since the audit report clearly shows the 1992 amount to be \$13.0 million, the audit team is not aware of the source of SWBT's \$22.2 million. SWBT apparently calculated the 1992 amount differently than the audit team and then attributed this different calculation to the audit team. The audit team's computation results in \$13.0 million as shown in the report and not \$22.2 million as SWBT suggests.

SWBT's computation, "based on the audit team's philosophy, resulted in a reduction of that allocation to only \$37.6 million." SWBT has understated the four-year total by a factor nearly as high as its overstatement of the 1992 amount, discussed above. Finally, the audit team's computations were based on company supplied data.

**JOINT AUDIT TEAM'S REPLY COMMENTS TO SWBT'S ANALYSIS OF JOINT AUDIT
REPORT ON AFFILIATE TRANSACTIONS**

ALLOCATION OF COSTS FROM SBC TO SWBT

Documentation for Time Charging

SWBT, in its comments on the joint audit report, takes the position that accurate and auditable documentation of SBC's employees' time charging is unnecessary and not required by either regulations or the company's procedures. The audit team strongly disagrees. The audit team is surprised by SWBT's position since, in mid-November 1993, SBC provided the audit team with a revised CAS Users' Guide, dated September 1993, which includes changes in the very practices the audit team has taken issue with. The audit team notes some of the more significant changes in the CAS, specifically, at page 3, Section 3:

" To ensure ongoing regulatory compliance and CAS integrity, all SBC employees will be required to annually review for correctness their standard CCN assignments and percentages used in the allocation of salary. The Corporate Manager-Regulatory Issues will coordinate this verification exercise. Each employee will be required to provide the support used in determining their CCN assignments and percentages. Managers may want to consider conducting annual time studies which would be a strong means of support for CCN assignments."

The audit team also notes the added requirement that "[a] copy of the completed time study should be forwarded to the Corporate Manager-Regulatory Issues." The audit team believes these significant changes in SBC's time reporting process are a step in the right direction to provide the documentation for time charging, on a going forward basis, that the audit team found lacking in the current audit. Although a retention period has not been specified by SBC, the audit team suggests that the documentation be retained for a sufficient period so that it will be available in future audits. The audit team also believes that documentation for time charges should be available. This could include the "survey time study" provided for in the CAS Users' Guide and any other contemporaneous record,

e.g., calendar notations, diaries, appointment logs, daily time planners, correspondence, or any other departmental records.

The company's characterization that the interviews of SBC's employees in San Antonio were unnecessary is unfounded. The audit team sought alternate documentation, such as that mentioned above, which might have helped the audit team determine that the allocators derived from time reporting were accurate.

SWBT has attempted to create an issue over the distinction whether SBC's cost allocation system is driven by survey time studies or accurate reporting of time. The audit team would have accepted survey time studies, or any other contemporaneous time record as support for time charges. In any case, the audit team is in full agreement with SWBT that the goal of any time reporting system is the accurate reporting of time. Section 32.12 (b) of the Uniform System of Accounts requires, in part, "...The detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission." SWBT states that this rule "...deals with a carrier's, not a parent company's, 'financial records'..." In making this assertion, SWBT implies that since SBC is a parent company and not a carrier, Section 32.12 (b) does not apply to SBC. By focusing on the narrow issue of "survey time reports" which are not required by the Uniform System of Accounts, rather than the broader and more substantive issue of adequate supporting documentation for time charges, SWBT seems to imply that, as a parent company, SBC does not have to support the transactions which led to the accounting entries made by SWBT, based on the charges from SBC. The audit team believes that this is a serious issue and SBC must support its time charges with some form of documentation. The audit team would have considered a reasonable alternate form of documentation, however, none was provided.

SBC provided the audit team with some documentation for 1993 time charges. Although out of the audit period, the audit team nevertheless examined the data. One department provided the audit team with a one-page summary of its time which it referred to as a "grid". This "grid" did not include any details, rather it was a summary of where each member of the department was charging his time. Another department provided the audit team with a four-week time study for each employee which indicated, on a day-by-day basis, what the employee had been working on. This is the type of documentation the audit team was looking for in order to support time charges. Based on the audit team's

analysis of the distribution of each of the twelve employees time, both before and after the time study, the audit team noted a significant shift in time charging. Before the time study, approximately 15.4% of the department's time was retained by SBC. After the time study, approximately 32.1% of the department's time was retained by SBC. The difference between the two percentages represents costs which had previously been allocated, mostly to SWBT, and are now retained by SBC. The extent of any possible misallocation cannot be quantified because the audit team has no way of knowing the time period over which the changes in departmental functions, which presumably caused the change in allocations, occurred.

SWBT is critical of the audit team's reluctance to accept its assurances that time charging at SBC is correct, even though there is a lack of documentation for such claim. SWBT should bear in mind that the audit team did not claim that SBC's time reporting was inaccurate. Rather, the audit team was unable to reach an independent conclusion that the cost allocators in use were accurate, because of lack of evidentiary support. The audit team remains unconvinced that it should change its conclusion merely because SWBT thinks the audit team should accept, without sufficient verification, what SWBT tells the audit team.

Finally, SWBT's contention that the audit team acted in bad faith by presuming bad faith on the part of SBC is not belittling SWBT. The audit team believes this is a gratuitous accusation. It is the audit team's position that proper documentation for time charges is an essential element of any well-designed cost allocation system.

SBC Marketing Allocator

The audit team does not ignore the concept that costs should be assigned on a cost causative basis. On the contrary, this is the very basis which it advocates and which is the foundation of the entire cost allocation concept. On the basis of SWBT's comments, it appears to the audit team that SWBT is taking issue with this concept which is clearly stated in the Joint Cost Order. If SWBT disagrees with the prescribed methodology for developing the marketing allocator, it should file for a waiver of the rules as they currently exist.

The audit team questioned the formula used to allocate SBC's marketing costs since it is based on a combination of SBC directly-incurred marketing costs and subsidiary directly-incurred marketing costs. This practice is clearly not in conformance with the affiliate transactions costing standards, which provide that only the allocating company's incurred costs should be included in the formula. The formula proposed and utilized by SBC effects a disproportionate assignment of marketing costs to SWBT. Contrary to SWBT's position, the audit team believes that SWBT has misapplied the affiliate transactions rules.

SWBT focuses its response on the marketing allocator issue strictly on the image or promotional advertising expenses, when the expenses at issue also include marketing support expenses. SWBT implies that, because it is the largest subsidiary of SBC, it must benefit from image advertising, presumably, in direct proportion to its relative size. The audit team was not provided with documentation to support such claim. Furthermore, the audit team strongly disagrees that image advertising benefits primarily the telephone company. On the contrary, the audit team believes that SWBT's affiliates would be the primary beneficiaries of image advertising by association with SWBT, the company which has the established reputation and which has been in existence for the longest time.

SWBT apparently recognizes three types of marketing costs: image, product specific, and residual. The audit team is familiar with the first two types, but does not recognize residual marketing costs as a unique type of advertising. Instead, the audit team views residual marketing costs as the portion that remains (is left over) after those marketing costs which can be directly assigned are directly assigned. In the audit team's view, residual marketing costs may certainly be of the image type. SWBT, however, seems to treat residual marketing costs and image type marketing costs as mutually exclusive costs.

The audit team fully understands the normal process of accruing for an expense in one year and reversing it in the next. The audit team is perplexed, however, by SBC's presentation of numbers. In the audit team's view, what seems to have occurred is a misclassification of expenses by SBC, which SWBT is characterizing as a misunderstanding by the audit team. In December 1991, SBC made an accrual entry as a direct charge to SWBT. This entry was reversed in 1992. In the normal accounting process, if the accrual was accurate, receipt and recording of the actual bill in 1992 would

zero out the accrual. This process accomplishes the goal of assigning the costs to the period in which the economic benefit of the cost was received. In this particular case, SBC recorded the actual bill in a cost pool which was to be allocated. This caused the reversal entry to remain negative rather than zero out. As such, the direct charges to SWBT were overstated in 1991 and understated in 1992. Since the amounts are immaterial and the errors offsetting, the audit team will not pursue this matter any further.

SBC GENERAL ALLOCATOR

SWBT's comments in this section of its response to the joint audit report take issue with the audit team's conclusion that the costs "retained" by SBC should be included in the calculation of the general allocator to determine the amount of residual costs to charge to SWBT. The audit team disagrees with SWBT's comments on this topic, and continues to fully support the audit conclusions set out earlier in the report.

SWBT's comments assert that retention of costs by SBC is neither an "assignment" nor an "attribution" of costs to operating subsidiaries, and therefore should not be reflected in the calculation of the general allocator, per the FCC CAM guidelines. SWBT further states that such a practice will lead to illogical and inconsistent allocation results. The audit team disagrees with these assertions. The audit team's conclusion on this issue is based upon an appropriate identification of the parties that benefit from SBC's projects and services. SBC's direct charges of costs are based on benefits received; i.e., if a SBC project or service benefits SWBT, but not other subsidiaries, the costs should be direct charged to SWBT. It should be indisputable that the benefits of certain SBC activities do not accrue to any of the subsidiaries, including SWBT. These activities would include, among other things, costs associated with merger and acquisition opportunities and new venture start-ups. In a very real sense, SBC and not its operating subsidiaries are the beneficiaries of such efforts. SBC appropriately retains the costs of these activities, rather than charge them to the operating subsidiaries. By retaining such costs, SBC is effectively "direct charging" such costs to itself, which substantively is as appropriate an assignment of costs on the basis of benefits received as is the direct charging of other costs to SWBT. SBC direct charges should be treated no differently than direct charges to SWBT for purposes of allocating residual costs. The audit team's conclusion that SBC retained costs should be reflected as a direct charge to SBC in calculating the general allocator is

conceptually consistent, logical and fully within the intent and the spirit of the CAM procedures. In contrast, SBC's current practice of eliminating its retained costs from calculation of the general allocator is illogical and inconsistent in that it results in a process wherein direct costs are allocated on the basis of benefits received, but indirect costs are all arbitrarily assigned to the operating subsidiaries regardless of the benefits which accrue to SBC (and not to the subsidiaries) from certain SBC activities.

SWBT's comments criticize the "pretense" that retained expenses are assigned or attributed to stockholders, noting stockholders are not billed for such expenses. The audit team, of course, is aware that SBC does not send bills to its shareholders to recover amounts that SBC retains. The important point is that SBC does not send bills or otherwise charge its operating subsidiaries for amounts that it retains either, and consequently such amounts are not intended to be recovered from the customer base of the SBC subsidiaries. Accordingly, in regulatory theory, SBC shareholders are responsible for SBC's retained costs.

SWBT further criticizes the audit team's conclusion by asserting that the resulting allocation to SWBT, if retained costs were reflected in the general allocator, would be much less than allegedly justified by SWBT's relative size within SBC. This suggested alternative wholly misses the point. Costs should be allocated to SWBT based on the benefits it receives from services performed by SBC, not allocated arbitrarily on the basis of SWBT's size compared to other operating subsidiaries. In this respect, it is worth reiterating that out of the total costs direct charged to the operating subsidiaries and to SBC, SWBT is charged only 36% of that total amount. Given this fact alone, it appears to be inequitable and unfair to allocate to SWBT 75% or more of SBC's residual costs, as would be justified using "size" as the relevant criteria.

In its comments, SWBT states that SBC is likely to change its purported "conservative" policy in regard to retention of costs if the conclusions of the audit team in this matter are implemented. The audit team is aware of no evidence that the costs retained by SBC do, in fact, benefit SWBT and believes that SBC's policy of retention of costs is clearly appropriate as it is now practiced. If SBC's policy in regard to retention of costs changes for any reason, the audit team would encourage the regulatory bodies with jurisdiction over SWBT to closely monitor the resulting allocation of costs to SWBT to ensure that only costs which benefit SWBT are charged to customers for ratemaking

purposes.

SBC Corporate Relocation Costs

SWBT has expressed concern that the audit team expanded the audit scope and standard in order to arrive at an adverse finding regarding SBC corporate relocation costs. The audit report is quite clear that the information provided is not a finding. It is information that came to light during the course of the audit respecting what is clearly an affiliate transaction.

In this current audit, the charge for corporate relocation appeared as the largest single line item in SBC's 1992 financial reports. Furthermore, the cost center title was "Capital Insurance Premiums", and this only added to the uncertainty. The use of the title "Capital Insurance Premiums" was, apparently, misleading for SWBT as well. The journal entry provided to the audit team in support of the charge to SWBT indicated that this cost was originally recorded in the Prepaid Insurance Account (Account 1310) and subsequently reversed and recorded in the appropriate account. Based on the large dollar amount and the vague cost center title, questions were asked, data requests were submitted, and data responses were received. The audit team is surprised at SWBT's response that it had no idea the audit team was looking into this area.

TRANSACTIONS FROM AMI TO SWBT

Office Space

1. Determining Prevailing Market Price.

SWBT states prevailing market price (PMP) cannot be determined by "merely averaging the prices paid by unaffiliated third parties". The affiliate transaction rules explicitly require that if a substantial third-party market exists, charges for services should be recorded into the company's regulated accounts at no greater than PMP. The rules do not state that the company may substitute FDC as the cost standard in lieu of PMP, as SWBT has done. Since a substantial third-party market obviously existed for AMI's office space lease services, in order to be in compliance with the affiliate transaction rules, PMP must be the rate recorded in SWBT's books of record. The audit team used average rates for presentation purposes only. The build-outs were included in the total lease rates because, as noted by SWBT in their comments, "a variety of factors including location, view, access, parking, length of lease, space required and build-out will influence the cost per square foot in the same building". Therefore, the build-outs were included in order for the lease rates to SWBT to be comparable with build-outs or any other "extras" which are included in the leases to non-affiliates.

Hotel Majestic Issues

1. Unused Room Billings to SWBT.

SWBT attempts to justify the fact that SWBT is charged for all unused rooms by stating that SWBT is the beneficiary of the guaranteed reserved block of rooms. However, this statement ignores the fact that SBC and all other affiliates using the Hotel are also beneficiaries. The audit staff maintains SWBT and its ratepayers inequitably bear the total charges for unused rooms while all SBC affiliates benefit from the resulting lower rates.

2. Room rate differential.

SWBT states that the room rate differential was "offered to encourage use of the Hotel Majestic, for which SWBT has a very favorable contracted room rate, in comparison with comparable hotels in downtown St. Louis". The audit team questions this practice. If the contracted room rate at the Hotel was so favorable, it would not be necessary to offer rates cheaper than the contract rates, at the total expense of SWBT and its ratepayers.

SWBT states that since the audit team had been advised that the room rate differential process was discontinued in September of 1993, the audit team's concern of this issue had already been addressed. The audit team submitted a data request to the company on August 10, 1993, requesting an explanation of how these monthly rate differential billings are calculated. The company's written response provided August 31, 1993 made no mention of the fact that this procedure would be discontinued in September. The audit team was not advised of the discontinuance of this billing procedure until a follow up telephone conversation on September 7, 1993, after the audit team had questioned the treatment of these charges by SWBT. The audit team was also advised at that time that there was no written documentation available to substantiate the change in this procedure since it was an internal procedure within SWBT. Due to the lack of written documentation which apparently enables SWBT's Travel Services Division to easily change these billing procedures, the audit team remains concerned about the Travel Services billing process and believes this is an area that should continue to be monitored in the future.

3. Prevailing Market Price (PMP).

SWBT states that a comparable prevailing price cannot be established for the rooms at the Hotel Majestic due to the unique contractual relationship (reserved rooms and a set guaranteed rate) and the fact that the room rates may vary from night to night. The company is incorrectly asserting that since the Hotel does not have a contract with another third party with terms identical to the one with SBC, it is not possible to establish a market price for its rooms. Additionally, the company should not be allowed to simply ignore or violate the affiliate transaction standards because the PMP may vary from night to night. The audit team believes that a substantial third party market clearly exists for rooms at the

Hotel Majestic which are available for rental to the general public and business groups. As the audit team noted in the report, the Hotel Majestic has offered special rates for business groups as low as \$85. These group rates may serve as a range to establish a PMP during the week. The normal PMP on weekends should be the Hotel's established weekend rate of \$49, unless otherwise substantiated by the Hotel for special events.

The facts remain as follows: Under SWBT's current policy, if a SWBT employee rents a room from the Hotel Majestic on a weekend night, SWBT is charged the contract rate of \$80, which is recorded into its regulated accounts. If a third party guest rents a room on the same weekend night, the guest is charged only \$49, barring special circumstances. This example explicitly highlights the purpose of these affiliate transaction standards to avoid excess charges for affiliate services above market prices, and illustrates the inequity that may result when the standards are violated.

4. Cost Information Included on Invoices.

SWBT states that it would be nothing more than a "redundant exercise" to comply with its Internal Operating Practice (OP) which requires SWBT's affiliates to provide the applicable PMP or FDC on the invoices for services provided to SWBT. The audit team disagrees, and, as stated in the report, believes this information is essential for SWBT to properly record charges to its regulated accounts. As discussed above, PMP is the proper cost standard for the Hotel Majestic's room rates pursuant to affiliate transaction rules. These rules require that the company record no greater than PMP in its regulated accounts. As admitted by SWBT, the PMP for the room rates may vary. Therefore, in order to properly record the room charges, SWBT must have this information available on the invoices.

AMI Home Relocation Services

1. EDC Calculation.

SWBT states that the audit team misunderstood the development of the general allocator in paragraph 75a of the audit report. The company then proceeds to address the development of AMI's general allocator. The conclusion of the audit team in paragraph

75a, however, did not address the general allocator. The audit team noted an error in the "calculation of the factor used to allocate AMI's rate base items to this line of business" (Option 1, or Regular Home Sales). (Emphasis added.) Specifically, this factor was used to allocate AMI Accounting and General Headquarters rate base to Regular Home Sales rate base. Therefore, the company's comments regarding this error noted by the audit team are not relevant.

2. Authorization of Home Relocation Contract.

SWBT states that the Home Relocation Services Agreement does not require authorization by the appropriate SWBT employees as established in its Schedule of Authorizations on Affiliate Transactions since SBC authorized the contract. Under this argument, SBC would be able to commit SWBT to any type of contractual agreements with any of its affiliates, without SWBT's authorization. The audit team believes this type of situation could be potentially harmful to SWBT and its ratepayers, and the safeguards established by SWBT's Schedule of Authorization on Affiliate Transactions should not be ignored.