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March 3, 1995

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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]

Dear Mr. Rauch:

Enclosed for filing in the above-captioned case are an original and fourteen (14) conformed copies of **STAFF'S HEARING MEMORANDUM**.

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

Thank you for your attention to this matter.

Sincerely,

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

TRS/bas
Enclosures

cc: Counsel of Record

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MISSOURI
PUBLIC SERVICE COMMISSION

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

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

STAFF'S HEARING MEMORANDUM

The Staff and Southwestern Bell Telephone Company (SWBT or Company) filed a Stipulation and Agreement on February 16, 1995 in this docket. That Stipulation and Agreement set out items and procedures on which SWBT, the Staff and the Office of the Public Counsel (OPC) had reached agreement concerning SWBT's affiliate transactions. The parties will identify and set forth their positions on disputed issues in separate documents in this round of filing. The Staff's position was substantially set forth in its statement of position on October 21, 1994.

**I. SWBT AFFILIATE TRANSACTIONS
STANDARDS/PRACTICES**

The Staff understands that SWBT takes the position that this Commission has adopted the FCC affiliate transaction rules in toto by adopting Part 32 of the FCC's rules in its Report and Order in TC-89-14; and that those rules, as presently written, adequately protect monopoly ratepayers. However, the Staff contends that the current FCC rules do not constitute the exclusive standards for

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**MISSOURI
PUBLIC SERVICE COMMISSION**

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SWBT affiliate transactions in Missouri. The Commission should specify adequate standards for SWBT affiliate transactions, many of which are included in the FCC's proposed amendment of Part 32¹. If this Commission determines the present FCC rules do apply, it should direct SWBT to change a number of its current practices to better protect Missouri ratepayers.

II. DEFICIENCIES IN CURRENT STANDARDS/PRACTICES

The Staff contends that the Commission should address at least three deficiencies in current SWBT practices:

A. The Personnel at SWBT's parent, a portion of whose salaries are charged to SWBT, have failed to adequately document how they spend their time. The absence of such documentation precludes the Staff from analyzing, and proposing specific adjustments to, the allocations of such expense to SWBT. The Commission should order adequate documentation and eliminate such SBC costs from SWBT revenue requirement for noncompliance.

B. Under current SWBT cost accounting practices, based upon incremental costs, it is unclear that SWBT includes all relevant costs in converting incremental costs to FDCs, making it impossible to specify needed adjustments. The Commission should order SWBT to conduct its cost studies to permit meaningful, complete, and

¹The FCC proposed substantial changes to its affiliate transactions rule for common carriers in September, 1993. The comment period closed in January, 1994. The FCC has not yet taken action on its NOPR. The Staff attached the FCC NOPR to its October 21, 1994, filing in this docket.

documented analysis of claimed fully distributed costs.

C. SWBT application of the FCC's prevailing Market Price rule involving purchases from affiliates does not use a reasonable percent of market sales. The rule provide that an affiliate's prevailing price to non-affiliates can be used to price sales to SWBT, but there must be substantial sales to non-affiliates. SWBT contends that ten percent of sales is sufficient to qualify as substantial under this provision. The Staff feels that the FCC's proposed move to a 75 percent of sales standard is reasonable, but that the Company's use of ten percent is not a proper reflection of market price.

The Staff detailed in its October 21, 1994, filing the changes it felt were needed in affiliate transaction standards and practices to protect captive Missouri customers of SWBT². It repeats those suggestions briefly, below.

III. THE STAFF'S AFFILIATE TRANSACTIONS STANDARDS

A. Purchases

Before purchasing either goods or services from its affiliates, SWBT should solicit bids from other vendors. If the value of a particular transaction does not warrant a formal bid process, SWBT should gather and maintain informal bids, or other

²The Staff reiterates here its previous suggestion that adequate regulatory safeguards against unlawful cross-subsidization of non-regulated activities by regulated services requires scrutiny of the separations between the regulated and deregulated activities of SWBT itself. Absent such safeguards, regulated monopoly services can be used to subsidize non-regulated activities.

market value indicators such as catalog prices, newspaper advertisements and the like.

For certain transactions, notably parent company services and research and development services, solicitation of bids may not be practicable. In such circumstances, affiliate transactions should be recorded at the lower of fully distributed costs (FDC) or fair market value indicators.

B. Sales

Sales from SWBT to its affiliates should be at tariffed rates, if such rates are published and available to the general public. Absent tariffed rates, the sales of goods should be at the higher of fair market value or net book value. Sales of services should be at the higher of fair market value or fully distributed costs of SWBT.

IV. PROCEDURES NECESSARY TO PERMIT MONITORING OF AFFILIATE TRANSACTIONS

A. Purchases from Affiliates

SWBT must generate and retain bids, or market information on purchases from affiliates before entering contracts to purchase either goods or services from the affiliate.

1. Parent/research and development transactions

The Staff acknowledges that bids for the services provided by SWBT's parent, SBC, and research and development costs obtained from Bell Core may not be practical. For such transactions, SWBT must apply appropriate cost allocation procedures. The Staff suggests, however, that SWBT be required to gather expenses for the same services for similar companies to serve as a reference point.

2. Affiliate cost issues

i. Allocation Methodology

The cost of items related to more than one specific transaction should be allocated using fully distributed cost principles.³

ii. Rate Base

The carrier and its affiliates should use the same rate base elements in determining the cost of an affiliated transaction. Both parties should use only elements of rate base approved by the Commission in the Company's last rate case.

iii. Rate of Return

The rate of return used by the affiliates should be the Company's rate of return from its last rate case.

iv. Expenses

Only those elements of expense allowed by the Commission in Company's last rate case should be included.

B. Sales to Affiliates

For non-tariffed sales of goods or services to affiliates, SWBT's price to affiliates should be the higher of its fully distributed cost or the fair market value of the goods or services. To effectuate this pricing practice, SWBT costing procedures must insure that all relevant costs of providing the good or service to the affiliate are considered and are included in the price.

³The costs identified by affiliates in sales to SWBT should be the same as the elements of cost which SWBT uses to determine cost of its sales to its affiliates. A schedule of such costs should be identified for each affiliate transaction, both SWBT purchases and sales.

Further, all cost elements which any affiliate includes in FDC computations for sales to SWBT must be included by SWBT in its sales to affiliates.

SWBT purchases substantial amount of professional services from non-affiliated outside vendors. SWBT prices for services it provides to affiliates should not be less than those which SWBT paid for similar services. SWBT should regularly benchmark its prices to its purchase of similar services from non-affiliated vendors.

V. MONITORING PROCEDURES

A. Estimating and True-Up Procedures

Where actual cost information is not available in a timely manner, SWBT must have in place adequate procedures to estimate costs, monitor the estimates' accuracy, and true-up estimates to actual results within 15 months after the close of the period of the estimate. SWBT may not base any of its affiliated transaction cost methodologies on estimates which are not trued-up to actual experience.

B. Employee Related Procedures

SWBT must be able to specify the specific job positions responsible for implementation and compliance with the affiliated transaction requirements. Written job descriptions and job expectations must contain evidence of the affiliate transaction responsibility. The job must not have other responsibilities which conflict with implementation of affiliated transaction

requirements. SWBT must document that the individuals in these positions have adequate training to understand and comply with the affiliated transaction rules.

C. Cost Allocation Manuals

The FCC currently requires large carriers, including SWBT, to file cost allocation manuals (CAMs) detailing cost apportionment procedures and update them quarterly. The Staff recommends that SWBT file its CAM with this Commission and update it quarterly. The Staff endorses the changes to CAM requirements proposed by the FCC in its September, 1993, Notice of Proposed Rulemaking.

D. Scope of Affiliated Transactions

The affiliated transaction accounting requirements should apply to any transaction within SWBT, for both regulated or deregulated operations, and between any affiliated enterprise.

E. Audit Trail Components

1. The audit trail documents compliance with affiliated transaction requirements, and assumes that all items necessary to support financial reporting and internal control procedures will likewise be maintained for the affiliate transaction decision-making process. For this reason this audit trail must be maintained for the same time period and should be consistent with the document retention procedures.

2. The FCC external attestation audit should be expanded to include any state specific affiliated transaction requirements.

3. The Company's internal audit group should be

required to perform regular periodic audits of the affiliated transaction requirements to verify compliance and necessary documentation retention period.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 3rd day of March, 1994.

Thomas R. Schwarz, Jr.

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