40

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October 21, 1994

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

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

Dear Mr. Rauch:

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

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

Thank you for your attention to this matter.

Sincerely,

Thomas R. Schwarz, Jr.

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

TRS:bes
Enclosures

cc: Counsel of Record

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MISSOURI
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OCT 21 1994

MISSOURI
PUBLIC SERVICE COMMISSION

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

Case No. TO-94-184

STATEMENT OF THE STAFF'S POSITION

In the Commission's September 13, 1994 Order in this docket, the Commission ordered the Staff to file on or before October 21, 1994, the following:

A. The Staff's position on the proper standards to adopt for affiliate transactions.

B. The Staff's position on the necessary procedures to ensure compliance with the Staff's proposed standards.

C. The Staff's position concerning the necessary components of an audit trail.

A. Position on Affiliate Transactions Standards

The State of Missouri has not developed nor adopted any state specific affiliated transaction rules. The current affiliated transaction standard applicable in Missouri is the Federal Communication Commission (FCC) affiliated transaction rule, adopted by the FCC in their Joint Cost proceeding Docket No. 86-111. In this docket the FCC set forth the federal jurisdictional accounting requirements for transactions between carriers and their non-regulated affiliates. The affiliate transaction rules are codified in Part 32 of the Uniform System of Accounts (USOA), that the FCC has promulgated so that carriers will record their costs and revenues in a uniform and systematic manner. The rules were

4

adopted as a part of a comprehensive effort to provide safeguards against improper cross-subsidization of non-regulated activities or entities by regulated carriers. These rules set forth the specific method that dominant interchange carriers (IXCs) and non-average schedule local exchange carriers (LECs), such as Southwestern Bell Telephone (SWBT), must use in determining the amounts to record in their (USOA) accounts for transactions with affiliated entities. Although the specified valuation methods are mandatory for federal accounting purposes, the rules neither regulate the prices at which affiliate transactions occur nor preclude the states from adopting different valuation methods for intrastate regulatory purposes.

The FCC's affiliate transaction rules distinguish between asset transfers and provision of services. For asset transfers, the rules provide for four valuation methods: tariffed rates, prevailing company prices, net book cost, and estimated fair market value. *Carriers must record each asset transferred to an affiliate* at the tariffed rate if a tariffed rate exists. If an affiliate that is selling a non-tariffed asset to a carrier has also sold the same kind of asset to a substantial number of third parties at a generally available price, the carrier must record the asset transfer at the prevailing company price. If the tariffed and prevailing company price valuation criteria are not met, the asset transfer between affiliates must be recorded at the higher of net book cost or estimated fair market value when the carrier is the seller, and at the lower of net book cost and estimated fair market value when the carrier is the purchaser.

The FCC affiliated transaction rules for services provide for three valuation methods: tariffed rates, prevailing company prices, and fully distributed costs. Services provided to an affiliate must be recorded at tariffed rates if tariffed rates exist. If the provider of a non-tariffed service also provides substantial amounts of the service to non-affiliates, the carrier must record the service at the price non-affiliates pay, which is called a prevailing company price. All other affiliate services must be recorded at the provider's fully distributed costs. The current FCC affiliated transaction rules do not use estimated fair market value as a valuation method for services.

It is the Staff's position that the current FCC affiliate transaction rules do not provide adequate protection to ensure that SWBT's books and records are not distorted as a result of affiliated transactions. Based on five year's experience, the FCC expressed similar concerns by publishing a Notice of Proposed Rulemaking (NPRM) on September 23, 1993, which proposed substantial tightening of its affiliate transaction rules. The NPRM proposed to amend the FCC affiliate transaction rules to enhance it's ability to prevent carriers from imposing costs of non-regulated activities on ratepayers, and to keep ratepayers from being harmed by carrier imprudence.

The Staff has reviewed the proposed FCC affiliate transaction rules and concurs that the proposed changes would correct many of the problems with the current rules. In this position statement the Staff suggests additional changes where the FCC proposed affiliate transaction rules lack sufficient detail to prevent abuse. The Staff has attached to this filing the FCC NPRM. The Staff will adopt an issue by issue approach in this filing because it is SWBT's position that the current FCC affiliate transaction rules are the appropriate standard. Thus, each proposed change to the existing FCC affiliate transaction rules can be treated as an issue in this docket.[1] The remaining portion of the Staff's discussion of affiliate transaction standards will follow the NPRM and/or Staff's proposed changes to the current FCC affiliated

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[1]

It is the Staff's position that the valuation standards and procedures must be consistent for affiliate transactions and SWBT's deregulated operations. If this is not done, then SWBT can avoid the affiliate transaction rules, if it chooses, by performing the function as a deregulated SWBT operation instead of having the function perform in a non-regulated affiliate company. For example, assume that SWBT can decide whether it wants to provide a video service as a deregulated operation or as an operation by a separate non-regulated affiliate. Further assume that the video service will need some equipment that SWBT presently has, and that this equipment is a significant component of the cost of the video service.; The affiliate transaction rules would require SWBT to record on its regulated books the higher of market value or net book costs. The Cost Allocation Manual (CAM) for deregulated operations would require that the equipment's net book cost be assigned to deregulated operations, since the CAM has no provisions for recording at a value greater that cost if the fair market value is greater than net book cost. SWBT can avoid this affiliate transaction rule by performing the video service as a deregulated operation. The Commission stated in its September 13, 1994 Order that it "has not determined that this docket should be expanded to consider deregulated operations. The Commission finds that it should first resolve the issues concerning affiliate transactions before it considers any other issues". The Staff respectfully asserts that a loophole, created by inconsistencies because affiliate transaction rules and deregulated cost allocation rules, should be an issue concerning affiliate transactions. Therefore it has addressed this loophole problem in its affiliated transaction standard position. However, in light of the Commission's September 13, 1994 Order it will not address this issue further.

transaction rules.

The Staff would recommend two alternatives concerning the procedural schedule subsequent to this filing. The first alternative is that the Staff and Public Counsel schedule a series of meetings with SWBT to determine what portions of the affiliated transaction standards, procedures, and audit trail can be agreed upon. This would be reported to the Commission in the form of a joint report and or stipulation & agreement. The parties would also file their positions regarding the disputed issues in either a separate report or joint hearing memorandum. The Staff would suggest December 15 for these filings. The second alternative would be that the parties file reply comments to the October 21 filings on November 15.

1. Tariff Rates

In its NPRM, the FCC proposed retaining the current requirement that, where tariffed rates exist for services or assets, affiliated transactions be recorded by the carrier at tariffed rates. The FCC proposed to treat as being provided pursuant to tariff only those affiliate transactions where the tariff is generally available, is on file with a federal or state agency, and is in effect. The FCC proposes that when all three conditions are met, then the affiliated transaction must be recorded at tariffed rates. To the extent all three conditions are not met, then the affiliated transaction would be treated as a non-tariffed affiliated transaction and other affiliated transaction rules would apply.

2. Prevailing Company Prices

The FCC proposed to divide SWBT's affiliates into two groups. The first group's primary purpose is to serve the SWBT and other Southwestern Bell Corporation (SBC) affiliates. The second group consists of the remaining affiliates, which do not have this primary purpose. SWBT cannot use prevailing company price as a valuation method for transactions between it and the first group of affiliates (i.e., those with the primary purpose to serve other affiliates) because the number of transactions between non-affiliates is insufficient. However, the prices that the first group of affiliates charge non-affiliates could be used to establish fair market value. The FCC tentatively concluded that any non-regulated affiliate that sells less than 75 percent of its output to non-affiliates has too large a volume of affiliate transactions to be deemed to have a predominant purpose of serving non-affiliates. Therefore, the FCC proposed to continue to allow prevailing company pricing only for affiliate transactions in which the non-regulated affiliate sells at least 75 percent of its output to non-affiliates.

3. Fair Market Value

The FCC proposed that carriers should record all non-tariffed affiliate transactions for which the FCC affiliate transaction rules do not permit the use of the prevailing company pricing valuation method at the higher of cost and estimated fair market value when the carrier (e.g., SWBT) is the seller, and at the lower of cost and estimated fair market value when the carrier (SWBT) is the purchaser. The current FCC affiliate transaction rules only applied this criteria to asset transfer. The FCC proposal would apply the above criteria to both asset transfers and provision of services. Net book cost is the relevant cost element for asset transfers. Fully distributed costs is the relevant cost element for provision of services.

4. Fully Distributed Cost

Both the FCC current and proposed rules require use of fully distributed cost to determine cost in the FCC's affiliated transaction rules(NPRM, par. 104-106). The FCC proposed to eliminate the distinction between asset and services regarding the use of a fair market value comparsion to cost.

B. Position on Procedures to Monitor Affiliate Transactions

The Staff's proposed procedures are broken down into two groups. The first group of procedures is specific to the four valuation methods discussed above. The second group of procedures is general to the affiliate transaction area.

1. Valuation Specific Procedures

a. Tariffed Rates

The required procedures are generally addressed in the Staff's Standard discussion. Three conditions are necessary if this valuation method is to be used. These conditions are that (1) the tariff is generally available, (2) the tariff is on file with the FCC or NPSC, and (3) the tariff is in effect. The conditions do not preclude the carrier from having a tariff that applies only to an affiliate or a group of affiliates. These conditions only preclude a carrier from using a tariff that applies only to affiliates to qualify for the tariffed rate method of valuation thereby avoiding application of the other affiliated transaction rules.

b. Prevailing Company Price

Procedures are needed for two areas. First, a definition is necessary regarding prevailing price. The Prevailing Company Price must include all consideration as value given to non-affiliated customers. These value considerations must include all discounts, inducements, warrantee, and guarantees.

Second, a definition is needed regarding the application of the 75 percent criteria. The FCC proposed two alternatives to measure the output from a non-regulated affiliate to non-affiliates. The first alternative would require carriers to measure each non-regulated affiliate's output using its actual revenues during the year for which affiliate transactions are to be valued. Under this alternative, carriers will be required to project annually, for the upcoming year whether each of their non-regulated affiliates will meet or exceed the 75 percent mark during the upcoming year. The revenue projections for affiliates are to assume that all affiliate transactions are provided at cost. A responsible person within the non-regulated affiliate should provide the carrier with a written representation that the non-regulated product or service to non-affiliated customers will meet or exceed the 75 percent mark in the upcoming year.

Thereafter, the carriers would follow one of two approaches, depending on the results of the initial projections. If the non-regulated affiliate being considered were projected to fall short of the 75 percent criteria mark during the upcoming year, the carrier would value that nonregulated affiliate's sales to affiliates at the lower of fully distributed costs and estimated fair market value. If the nonregulated affiliate were projected to meet or exceed the 75 percent mark during the upcoming year, the carrier would value at least some of the nonregulated affiliate's sales to affiliates at prevailing company prices. This approach would continue until updated projections or actual data change the results of the 75 percent criteria for the nonregulated affiliate in question. In addition, the accounting entries used to test the 75 percent criteria for the year must be based on actual versus projected data.

The second alternative would require carriers to measure output using the non-regulated affiliate's revenue from the immediately preceding year. If this approach is selected, then the carrier is required to apply the existing valuation method to determine whether each of their non-regulated affiliates had sold at least 75 percent of their output to non-affiliates during the calendar year immediately preceding the year any valuation methods become effective. This may need to be modified to allow time period after the calendar year for the actual calendar year results to be known. The results of these determinations would be applied throughout the year in which the new valuation methods become effective. Thereafter, carriers would use the new valuation methods to reevaluate annually whether its non-regulated affiliates meet or exceed the 75 percent mark. Under this approach, the final accounting entries for any given year would be based on the historical data for the preceding year.

A carrier can make a one time election to use either of the two alternatives. However the carrier cannot switch to the other method after its initial election without approval of the MPSC. This will eliminate the opportunity to change methods annually in the years that produce the minimum value for sales or maximum value of purchases for the carrier's regulated operations.

c. <u>Fair Market Value</u>

Procedures are necessary to prescribe the process required to estimate Fair Market Value. The FCC NPRM suggests that these procedures should vary with the circumstances related to the transaction, and does not specify the precise steps carriers should include in each particular estimation process. Rather, the FCC requires carriers to make a good faith effort to determine if fair market value exceeds costs when they transfer assets or services to non-regulated affiliates and whether costs exceeds fair market value when they acquire assets or services from non-regulated affiliates. If these efforts indicate that assets or services should be recorded at fair market value, then the FCC proposes that carriers make additional efforts to define that value.

The Staff believes that more specificity is needed. The data will be available to determine fair market value if the carrier has good purchasing and selling practices.

The Staff asserts that documents supporting carrier's purchase and sale decisions will be the primary source documents to determine fair market value. Bids, quotes, vendor selection documents, and provider value estimates would be data sources to develop estimates of fair market value. The purchase approval and authorization documents with the related supporting detail(e.g. cost/benefit analysis) are other data sources useful to estimate fair market value. Such data will exist unless the carrier is doing business with a non-regulated affiliate without allowing non-affiliates to compete and/or participate on equal footing for the same transaction. Qualified vendor lists, lists of vendors invited to submit quotes or bids, and instructions/information sent to all vendors are data sources that can be used to determine whether the carrier has excluded non-affiliated companies from the transaction. If the carrier excludes non-affiliates from a transaction, then it must maintain adequate documentation to support its decision. Absent sufficient reason and adequate documentation, for excluding non-affiliates, the carrier will face regulatory penalties such as expense disallowances or imputed revenue adjustments.

d. <u>Cost Method Procedures</u>

The FCC proposes that carriers record certain affiliate transactions at the costs to the affiliate group. Determining those costs involves several steps, and requires an accounting system that records what the affiliate group originally paid for the equipment and other resources used to provide affiliate transactions. Those resources used for multiple purposes will require an allocation process to determine the portion of costs related to affiliate transaction.

The relevant cost method for asset transfers between affiliates is net book cost.[2] Net book cost is defined as the original cost of the item to the affiliate group less any accumulated depreciation and other related reserves. When the transferor affiliate obtained the item from a non-affiliate, the original cost equals the amount the transferor paid the non-affiliate for the resource, plus any costs (e.g. freight) incurred in obtaining the resource from the non-affiliate. Accumulated depreciation reflects any depreciation accumulated based on prescribed depreciation rates of the FCC and/or Missouri Commission that relate to the item being transferred. If no prescribed depreciation rates are applicable, then the accumulated depreciation must be consistent with Generally Accepted Accounting Principles (GAAP). "Other reserves" are any other balance sheet reserve related to the item being transferred, e.g., deferred taxes.

When the cost item is recorded in an expense account the same procedures apply. When the transferor affiliate obtained these items directly from a non-affiliate, the cost of the item to the carrier is the amount paid to the non-affiliate plus any cost the transferor incurred in obtaining the item from a non-affiliate.

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[2]GAAP requires elimination of intra-corporate profit between affiliates, whether regulated or not.

The cost procedures must also address instances in which the transferor affiliate obtained the cost item from another member of the affiliate group. The FCC refers to these instances as "Chain Transactions". The FCC provides the following example:

> A nonregulated affiliate might purchase supplies from another nonregulated affiliate and then sell them to an affiliated carrier. The nonregulated affiliate that purchases the supplies could also use them to make products that it sells to the carrier or other affiliates. These products, in turn, could be transferred among affiliates or used to make additional products that are transferred among affiliates.

The FCC discusses two alternative cost procedures to address chain transactions. The FCC proposes that carriers be required to calculate the costs of items obtained from other affiliates in accordance with the valuation methods proposed in their NPRM. As an alternative, the FCC suggests that all resources used in affiliate transactions be valued at their original cost to the affiliate group even if they had previously been transferred between or among affiliates. The Staff prefers that the second alternative be used as the cost procedure for affiliated chain transactions, however the FCC's first approach is also acceptable.

Cost procedures should also address allocation methodology and allowable cost components. The allowable cost components are rate base, rate of return, and expenses.

i. <u>Allocation Methodology</u>

Some consideration must be made for cost items that are related to more than one specific transaction in determining the cost of an affiliated transaction. These cost items are to be allocated based on fully distributed cost principles using the same standards required for apportioning costs between regulated and deregulated operations. The cost to the affiliated group is the relevant cost basis for allocation. The fully distributed cost principle will require consideration of all costs of the affiliated group. The fully distributed cost studies will follow the general methodology used to develop the carrier's revenue requirements. The Company's capital costs (i.e., interest and equity return) are to be considered by the application of a rate of return to a rate base. Interest expense is not to be included again in with the other allowable expenses.

ii. <u>Rate Base</u>

Procedures are needed to ensure that a proper rate base is used to develop the cost of an affiliated transaction. The carrier's rate base is to be developed in accordance with the rate base developed for the company in its rate cases. These same principles are to be used to develop the rate base of a non-regulated affiliate. If the affiliate has unique circumstances that, in the carrier's opinion, require a deviation from the principles used in the company's last rate case, then the carrier must request approval of the variance from the Commission. Balance sheet items that are disallowed by the Commission from rate base determination are not to be included in the determination of rate base for an affiliated transaction unless explicitly approved by the Commission.

iii. <u>Rate of Return</u>

The affiliates rate of return should equal the rate of return and capital structures determined in the carrier's last rate case. This return consists of an equity cost component and a debt cost component applied to the affiliates capital structure.

iv. Expenses

Similar to the rate base procedures, the carrier must use the same methodology from its last rate case to determine allowable expenses in the development of costs related to affiliated transactions. Non-regulated affiliates must use the same methodology for their expenses unless a variance is approved by the Commission. Expenses that are disallowed by the Commission are not to be included in the determination of the cost of an affiliated transaction unless explicitly approved by the Commission.

2. General Procedures for Affiliate Transactions

General procedures must be developed to address implementation of and compliance with the affiliate transaction rules.

a. Estimating, Monitoring and True-up Procedures

The evaluation of affiliated transaction costs will require accurate information. Because accurate information is not always available in a timely manner, it will be necessary to develop procedures to estimate costs, monitor the estimate's accuracy, and make corrections for the estimate's inaccuracies. Carriers are expected to make good faith estimates and all estimates are to be trued-up to actual results within fifteen months after the time period for which the estimate was made. This process could apply to either estimation of an affiliated transaction cost or the allocation of an affiliated transaction common cost.

At no time may the carrier base any of its affiliated transaction cost methodologies on estimates that are not trued-up to actual experience. For example, the carrier cannot allocate any joint and/or common cost to an affiliated transaction that is based totally on an estimate. Any allocation estimate must be supported by written and verifiable documentation of related actual results.

b. Employee Related Procedures

Carriers are expected to have human resource procedures that ensure compliance with the Commission's affiliated transaction rules. The company must be able to specify the specific job positions responsible for the implementation and compliance for each aspect of the affiliated transaction requirements. The corresponding job descriptions and job expectations must contain written evidence of the affiliated transaction responsibility. The job position must contain no other responsibility that would conflict with full implementation and compliance of affiliated transaction requirements. The company must have written evidence that shows that the individuals that hold these job positions have received adequate training to fully understand the requirements of the affiliated transaction rules.

c. Cost Allocation Manual

Large carriers are currently required to file with the FCC cost allocation manuals (CAMs) detailing their cost apportionment procedures. These CAMs include data regarding affiliated transactions. For example,the CAM must include a chart showing all of the carrier's corporate affiliates. Each CAM must also identify the affiliates that engage or will engage in transactions with the carrier, and describe the nature, terms and frequency of those transactions. The FCC had determined that affiliate transaction rules apply to the carrier's non-regulated operations. The FCC proposes that a carrier's CAM must provide information on the carrier's affiliate transaction with its non-regulated operations to the same extent such reporting is required for the carrier's regulated operations. The FCC proposes that carriers report in their CAMs which of their affiliates meet the 75 percent sales to non-affiliates criteria. This information is to be updated quarterly in the CAM updates. The FCC proposed that carriers be required to discribe in their CAMs the carrier's procedures to determine fair market value.

The Staff would agree with the FCC CAM proposals. The Staff would also recommend that the carriers' CAMs be filed with the Commission and updated quarterly as is presently done with the FCC.

d. Affiliated Transaction Definition

It will be necessary to specify the scope of the affiliated transaction requirements. These requirements must apply to any transaction between affiliated firms that involve any of the carrier's regulated or deregulated operations.

e. Document Retention

Documents generated from the implementation and/or compliance with these affiliated transaction standards and procedures are to be maintained for a period that is the longer of either the carrier's normal document retention procedures or the date the Commission approves the destruction of these documents. The carrier may transfer the portions of these documents to the Commission's Staff in lieu of seeking Commission approval for document destruction if Staff can make suitable arrangements.

C. Audit Trail Components

The FCC proposed in its NPRM to incorporate an audit trail requirement into the affiliated transaction rules. Staff agrees that affiliate transaction rules should contain the requirement to maintain an audit trail.

This audit trail documents compliance with affiliated transaction requirements and assumes that all audit trail components necessary to support financial reporting and internal control procedures will likewise be maintained for the affiliate transaction decision-making process. The period of time that the audit trail must be maintained should be consistent with the document retention procedures. The FCC external attestation audit or external audit should be expanded to include any State specific affiliated transaction requirements. 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.

The Staff is to file a report with the Commission at the beginning of the first year the Commission's affiliated rules are to be effective. The purpose of this filing is to report the results of Staff's examination of the carrier's affiliate transaction documentation and procedures at the time of full implementation of the Commission's affiliate transaction rules. The Staff would estimate that calendar year 1996 will the first year that the Commission's affiliate transaction requirements will apply. After the first year of implementation the Staff will file a report of its findings regarding the carrier's compliance with the Commission's affiliate transaction rules. In subsequent years the Staff will review the audit workpapers of the carrier's internal audit of affiliate transactions and the workpapers of the external auditor's attestation audits.

Dated: October 21, 1994

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