In the Matter of	)	
	)	
Separation of costs of regulated telephone service from costs of nonregulated activities.	)	
	)	CC Docket No. 86-111
Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to provide for nonregulated activities and to provide for transactions between telephone companies and their affiliates.	)	

REPORT AND ORDER

Adopted: December 23, 1986; Released: February 6, 1987

By the Commission:

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I. INTRODUCTION

1. On April 17, 1986, we released a Notice of Proposed Rulemaking [FN1] seeking comment on methods for separating the costs of regulated telephone service from the costs of the nonregulated activities of telephone companies and their affiliates. We proposed to develop a system of accounting separation that would inhibit carriers from imposing on ratepayers for regulated interstate services the costs and risks of nonregulated ventures. Our ultimate, statutory goal was to promote just and reasonable rates for services in the interstate jurisdiction. [FN2] We tentatively concluded that, to achieve our purposes, it would be necessary to deter cost shifting both in the form of misallocation of joint and common costs and in the form of improper intracorporate transfer pricing. In this Order we affirm that conclusion by adopting (1) cost allocation standards and, for certain carriers, a requirement that a cost allocation manual be filed with this Commission; (2) rules for recording transactions between regulated telephone companies and their corporate affiliates; and (3) accounting procedures, audit requirements, and other implementation and enforcement mechanisms.

2. In this Order we adopt cost allocation standards for use in apportioning costs between regulated and nonregulated activities. These standards reflect a fully distributed costing methodology, with emphasis on direct assignment and cost causation. Costs are to be directly assigned either to regulated or nonregulated activities to the maximum extent possible. Costs which cannot be directly assigned are to be grouped into homogeneous cost categories and allocated in accordance with direct or indirect measures of cost causation. Telecommunications plant cost categories will be apportioned based on projected relative demand at the point during the average life of the plant in the category when demand is expected to peak. Residual costs which cannot be apportioned on any cost-causative basis will be apportioned in the same ratio as the directly assigned and directly and indirectly allocated expenses.

3. The cost allocation standards we are adopting herein will be used to segregate (a) the costs of activities which have never been subject to regulation as communications common carrier offerings, and (b), the costs of preemptively deregulated activities, from the costs which are subject to Part 67 of our Rules, the Jurisdictional Separations Manual. Costs of intrastate services which have been removed from tariff regulation in a state will continue to be separated in accordance with Part 67, and will not be subject to the cost allocation standards adopted in this Order. Billing and collection for interstate services will continue to be subject to Part 67, and interstate costs attributable to billing and collection services will continue to be determined in accordance with Part 69 of our Rules. Treatment of any interstate services which we may deregulate in the future will be decided on a case-by-case basis.

4. All local exchange carriers and dominant interexchange carriers will use these cost allocation standards, but only companies with more than $100 million in operating revenues will

be required to file and obtain approval of their cost allocation manuals. A Bell operating company will be required to obtain approval of its manual before it ceases to conduct its customer premise equipment (CPE) business in accordance with the Computer II structural separation conditions. Each company required to file a manual will also be required to submit annually the results of an independent attestation audit attesting that the cost allocation manual has been properly implemented and that the company's cost allocations are the product of accurate methods. Companies will be permitted to choose their own auditors.

5. We also adopt affiliate transaction rules which generally require that transactions between carriers and their affiliates be recorded on the carrier's books at market price, if market price can be determined from a price list or tariff. In the absence of a list or tariff price, assets transferred from the carrier to the nonregulated entity are to be recorded at the higher of net book cost or fair market value, while assets transferred from the nonregulated entity to the carrier are to be recorded at the lower of net book cost or fair market value. Services for which there exists no list or tariff price are to be valued in accordance with the cost allocation standards.

6. Finally, we amend Part 32 of our Rules, the Uniform System of Accounts, so as to discontinue the use of separate books of account for nonregulated activities that share common plant with regulated operations. Such activities will be recorded in operating accounts; accounting separation will be maintained using subsidiary records and reports.

II. BACKGROUND

A. Accounting and Cost Allocation in the Regulated Arena

1. The Uniform System of Accounts

7. One of this Commission's earliest acts in the exercise of its common carrier jurisdiction was to adopt Parts 31 and 33 of its Rules, the Uniform System of Accounts (USOA). [FN3] That USOA was a creature of its times, adapted to the regulatory and industry environment of the regulated monopoly era. Over the last two decades, as technological advances, the growth of competition, the proliferation of new products and services, and changes in industry structure dramatically altered that environment, the original USOA became obsolete. In 1978 we began the process of developing a new USOA. We initially considered creating a single regulatory information system that would provide not only ordinary financial data but also a detailed breakdown of costs by jurisdiction and by specific services. [FN4] Later we set aside that concept, deciding instead to develop an updated and improved financial accounting system that would be separate from, but would interrelate in a coordinated fashion with, the subsystems used to organize and analyze costs for use in regulation. Those subsystems include jurisdictional separations, the access charge rules, the Interim Cost Allocation Manual (ICAM), and the cost allocation system we are developing in the instant proceeding. We adopted Part 32 of our rules,

the new Uniform System of Accounts for Class A and Class B telephone companies, on May 1, 1986; it will be implemented January 1, 1988. [FN5] We are in the process of developing a new automated data reporting system to complement the new USOA. [FN6]

2. Separation of costs between the state and interstate jurisdictions

8. The dual system of regulation reflected in the Communications Act of 1934 requires the separation of common carrier costs and revenues between interstate and intrastate operations, so that we and the states may each regulate the provision of communications common carrier services within our respective jurisdictions. The procedures for performing jurisdictional separations are described in Part 67 of our Rules, the Separations Manual. [FN7] Section 410(c) of the Communications Act requires us to seek the assistance of Federal- State Joint Boards in revising and updating the Separations Manual. [FN8]

9. The jurisdictional separations process begins with the costs recorded in the USOA accounts. Those costs are first assigned to categories and subcategories. Each category of costs is then assigned or allocated [FN9] in accordance with a prescribed rule or principle. Although the Separations Manual categories are designed so as to group together those costs which can be identified as belonging to a single jurisdiction, most of the categories contain costs which must be allocated between the jurisdictions. Some of the separations categories are subdivisions of a single USOA account, while others combine costs which are recorded in several accounts. The Separations Manual is a fully distributed costing system, which means only that it exhaustively apportions the costs of a company's regulated operations between the jurisdictions. A Joint Board is in the process of revising the Separations Manual to conform to the new USOA. [FN10] That Joint Board is also considering proposals for simplification of the separations process.

3. Allocation of interstate costs

10. a. AT & T. During our first three decades we concentrated our ratemaking efforts on review of overall revenue requirements and determination of fair overall rates of return. We allowed the carrier latitude in deciding what portion of its revenue requirement to recover from each of its various offerings. The advent in the mid-60's of private line competition, however, focused attention on the natural incentive that AT & T might have to lower rates for competitive services by imposing some of the costs of those services on the ratepayers for monopoly services. Our increased concern about the effects of cost shifting on ratepayers and on competition launched us on a prolonged search for a method of allocating AT & T's costs to specific services. [FN11] In Docket 18128 [FN12] we explored a range of costing proposals. We considered possible applications of marginal costing and pricing to a firm engaged in both competitive and noncompetitive enterprises, but ultimately concluded that full, proportionate distribution of costs best furthered the purposes of the Act. [FN13] We also determined that a cost allocation method based on historical cost causation was, in theory, the most desirable approach to distributing full

costs. [FN14]

11. We never succeeded in actually using our preferred method to determine lawful rates for AT & T's services. This was caused in part by the massiveness and complexity of the data generated by AT & T's procedures. It may, however, have been in fact impossible to attribute AT & T's investment in telecommunications plant to particular private line offerings on a cost-causative basis, due both to the extreme fungibility of the plant and to the high degree of substitutability amongst the services. Faced with a pressing need for manageable cost allocation rules, we settled in 1981 upon an Interim Cost Allocation Manual (ICAM) [FN15] which used methods similar to those embodied in the Separations Manual to allocate AT & T's costs among several broad service categories. With modifications, ICAM remains in use today.

12. As competition has grown, we have begun to seek methods of assuring just, reasonable, nondiscriminatory rates while allowing dominant carriers more pricing flexibility than can usually be achieved with fully distributed costing. In the Private Line Guidelines Order [FN16] we adopted tariff review procedures which would decrease our reliance on detailed cost analysis as the principal means of assessing the reasonableness of rates. We found that fully distributed costing approaches were not useful for deciding if prices are so low as to be predatory. We discussed circumstances in which volume discount rates for large users might promote reasonable rates for all users, and we made it less difficult for carriers to show that rates below the rates which would result from full distribution of costs are needed to meet competition. Similarly, in the MTS Rate Guidelines Order, [FN17] we struck a balance between the carriers' needs for pricing flexibility and the need to forestall predatory or anticompetitive pricing by deciding to refrain from investigating MTS discount plans which the carrier can demonstrate will increase net MTS revenues.

13. b. Local exchange carriers. Part 69 of our Rules provides for the allocation of local exchange carriers' interstate costs amongst their interexchange services and the various rate elements that form the cost basis for their exchange access tariffs. Part 69 is a fully distributed costing system which is similar in approach to the Separations Manual.

B. Accounting and cost allocation approaches for nonregulated activities

1. Traditional accounting treatment

14. Telephone companies have always engaged in a certain amount of so-called "incidental" nonregulated activity. These activities did not traditionally cause regulators to be concerned about cost shifting or anti-competitive behavior because the activities were usually closely related to regulated activities and because they were for the most part very small. Accordingly, carriers have in the past been permitted to account for these activities in ratemaking accounts. [FN18] The costs have generally not been identified and disallowed in ratemaking, and

any revenues simply offset regulated revenue requirement. The USOA has always included below the line accounts for non- incidental, non-ratebase activities.

2. Traditional treatment of affiliate transactions

15. Transactions between communications common carriers and their nonregulated affiliates have always been subject to scrutiny in rate cases. This is due to the possibility that, in a non-arm's-length transaction, an affiliate may charge an excessively high price to the carrier. Since such prices become part of the costs and rate base of the carrier, they can lead to unreasonably high rates. Thus, for example, in our investigation in Docket 19129 [FN19] into the ratebase and revenue requirements of the then-integrated Bell system, we used our authority under Section 215 of the Communications Act [FN20] to inquire extensively into the relationships between the Bell companies and their manufacturing affiliates. [FN21] We have also exercised our authority under Section 219 of the Act [FN22] to require carriers to file annual reports with this Commission. [FN23] Some, but not all, states regulate intrastate affiliate transactions.

3. Structural separation of regulated and nonregulated activities

16. a. Computer I. The past two decades have seen not only the growth of competition in provision of traditionally regulated telecommunications services, but also the entry of telephone companies as competitors in nonregulated markets. Our regulatory responses to this trend have been evolving steadily since 1966, when we initiated what has since become known as the First Computer Inquiry, or Computer I. [FN24] In Computer I we decided not to regulate data processing services, but required common carriers other than AT & T and its Bell system subsidiaries [FN25] to provide data processing through separate corporate entities. Companies were to maintain "maximum separation" between their common carrier and data processing entities. The conditions for maximum separation required the separate corporations to maintain their own books of account, to have separate officers, and to utilize separate operating personnel, computer equipment, and facilities for their data processing offerings. The carrier was forbidden to sell or promote the data processing services of its subsidiary. Furthermore, carriers were prohibited from selling or leasing to any other entity any excess capacity or computer system component used in any way in the provision of common carrier communications service. Thus the Computer I structural separation scheme sought to control cost shifting in the form of misallocation of joint and common costs by simply forbidding joint operations and joint marketing. That prohibition, however, did not extend to nonregulated activities other than data processing.

17. We never had occasion to address cost allocation procedures for any administrative or general corporate overhead costs which carriers might have been able to share under the Computer I regime. We did, however, require that carriers file with us the terms and conditions

of every contract or other arrangement between the carrier and its data processing affiliate. This Commission's decision to impose further restrictions on affiliate transactions, forbidding a carrier from obtaining data processing services from its separate affiliate, was reversed upon judicial review. [FN26]

18. b. Computer II. Administration of the Computer I scheme required that we be able to distinguish between "data processing" and "communications," and to classify "hybrid" services in accordance with whether they most resembled data processing or communications. When it became apparent after just a few years that these distinctions could not be maintained, we began the Second Computer Inquiry (Computer II) [FN27] with the intention of establishing a new regulatory framework for the commingled provision of data processing and communications services by both carriers and their nonregulated competitors.

19. In Computer II we created a new definitional scheme based on a dichotomy between "basic" and "enhanced" services. Basic services were the traditional common carrier offerings of transmission service for the movement of information, while any other services offered over the telecommunications network were defined as enhanced. [FN28]

20. We removed both enhanced services and customer premises equipment from regulation as common carrier communications services at the federal and at the state levels. [FN29] We required all carriers owning transmission facilities to unbundle their basic and enhanced offerings, and to use their basic transmission facilities under the terms and conditions of their own tariffs when providing enhanced services. [FN30] While the "tariff rates" condition was intended mainly to prevent carriers from using their control of their networks to squeeze competitive enhanced service providers, it also functioned as a firm cost allocation rule for assigning transmission costs to the carriers' enhanced service operations.

21. As in Computer I, our realization that carriers would always have some natural incentive to shift costs to rate-of-return regulated activities impelled us to consider structural separation. This time, however, we concluded that the benefits of requiring a carrier to compete through a separate subsidiary in the CPE and enhanced services markets would exceed the costs only in the case of AT & T. [FN31] We required all other carriers to establish accounting separation by establishing separate books of account for CPE and enhanced services operations. [FN32] At divestiture we applied modified structural separation conditions to the Bell operating companies as well. [FN33]

22. c. Accounting Separation under the Computer II rules. Implementation of Computer II required, among other things, development of accounting and cost allocation rules to give substance to the "separate books of account" requirement. In the Fifth Report and Order in the Implementation Proceeding [FN34] we prescribed two new Part 31 accounts for nonregulated activities. Account 106 is an asset account entitled "Nonregulated Investment." Account 317 is

a profit and loss account entitled "Income from nonregulated activities." Account 106 reflects the carrier's net investment in nonregulated activities, and provides a record of costs transferred between regulated and nonregulated activities. The revenues and expenses of nonregulated activities are kept in the separate books of those activities, with the net results recorded in Account 317. Our aim was to approximate full equity accounting, thereby creating a separate accounting division for those nonregulated activities not conducted through a subsidiary. [FN35]

23. Under the Fifth Report and Order system, expenses associated with nonregulated activities are initially recorded directly in the nonregulated set of accounts or in accounts for regulated operations, depending on the nature of the expense and on how it is incurred. All nonregulated expenses which are initially recorded in accounts for regulated operations are transferred to Account 106 at the end of each month.

24. Investments dedicated entirely to nonregulated use are also recorded in Account 106. Investments in "common plant," that is, in plant used for both regulated and nonregulated purposes, are recorded in the accounts for regulated activities.

25. Our intention in the Implementation Proceeding had been, not only to prescribe accounts, but also to establish cost allocation rules to govern the distribution of shared expenses and common investment between regulated and nonregulated activities. When the record in that proceeding proved insufficient for the latter purpose, we deferred promulgation of cost allocation rules to the instant rulemaking. As an interim measure, we instructed the independent telephone (i.e. non-BOC) companies to use fully distributed costing to allocate costs to nonregulated activities. [FN36]

26. d. Allocation of joint and common costs between carriers and Computer II affiliates. The Computer II structural separation conditions generally precluded joint activity in operations and marketing, the areas which we deemed particularly susceptible to significant cost misallocation. On the other hand, our Computer II decisions expressly permitted the CPE and enhanced services entities to receive certain services from operating companies or other affiliates, [FN37] subject to approved accounting and cost allocation plans. [FN38] Special accounting plans have also been required as conditions upon various waivers of the Computer II rules. [FN39]

27. e. Affiliate transactions and asset transfers under Computer II. In the Computer II scheme we retained the Computer I requirement that carriers reduce to writing and file with this Commission the terms of their transactions with their separate affiliates. We stated that such transactions were to be compensatory, by which we meant that the carrier was to recover from its affiliate the full cost of transferred goods or services, including reasonable profits, overheads, and transaction costs, at the same terms, prices, and conditions that would be available to a nonaffiliated purchaser. [FN40] While we did not attempt to restrict operating companies from purchasing the products or services of their affiliates, our concern about the potential for

ratepayers to bear the cost of non-compensatory intracorporate transfer pricing lead us to prohibit the CPE or enhanced services subsidiary from marketing transmission or other network equipment. [FN41]

28. The transfer at divestiture of several billions of dollars worth of embedded CPE from the BOCs to AT & T-IS raised the question of how to value assets transferred from regulated operations. We had recognized that the equitable principles of Democratic Central Committee v. Washington Metropolitan Area Transit [FN42] govern the disposition as between ratepayer and shareholders of the capital gains or losses on such assets: gains or losses belong to the group which bore the risk of loss on the asset, or in the case of nondepreciable land, the financial burden of maintaining it. [FN43] We initially proposed that carriers follow these principles by transferring all CPE assets at their economic value, [FN44] but later decided for practical reasons to allow use of adjusted net book value as a proxy for the economic value of CPE. To satisfy Democratic Central Committee, we ordered the operating companies to offer ratepayers the opportunity to capture any capital gains on CPE through purchase at net book cost increased [FN45] only by transaction costs. Land and associated buildings, however, were transferred at appraised value. [FN46]

4. The Third Computer Inquiry (Computer III)

29. In August 1985 this Commission, recognizing that technology and the market place were again outpacing our regulatory schemes, initiated The Third Computer Inquiry (Computer III). [FN47] In our first Computer III decision, released June 16, 1986, [FN48] we determined that the benefits of structural separation for enhanced services, as compared with nonstructural safeguards, were not great enough to outweigh the costs which structural separation imposed on the public. In accordance with this determination, we replaced structural separation with a set of nonstructural safeguards, [FN49] including the cost allocation rules we are adopting herein, and Open Network Architecture (ONA). [FN50] Because ONA will take some time to develop, we allowed AT & T and the BOCs to offer specific enhanced services on an unseparated basis pursuant to approved Comparably Efficient Interconnection (CEI) plans. We also allowed them, pending completion of the instant proceeding, to file interim cost allocation plans based on the proposals in the Joint Cost NPRM.

5. Structural relief for CPE activities

30. a. AT & T. In September, 1985, we decided in the AT & T Structural Relief Order [FN51] that AT & T's post-divestiture circumstances no longer warranted requiring structural separation for AT & T's provision of CPE. We ordered AT & T to submit a detailed accounting and cost allocation plan before beginning to provide CPE on an unseparated basis, and to submit its operations under that Plan to an annual independent audit, at its own expense. AT & T made the required submission on October 8, 1985. Following procedures established in the AT & T

Structural Relief Order, the Common Carrier Bureau conducted an initial review of the plan and, on November 27, 1985, approved implementation of the plan on an interim basis. At the same time, public comment was solicited on the plan and a more detailed review was begun. On July 11, 1986, the Common Carrier Bureau released an Order extending its interim approval of the plan, but seeking clarification and additional information, including data on cost allocations made under the plan during 1986. The Bureau ordered AT & T to file certain of these data quarterly for as long as the plan remains in effect, that is, until the plan is superseded by a permanent cost allocation manual meeting the requirements established in this proceeding.

31. b. The BOCs. On January 12, 1987, this Commission released a Report and Order [FN52] establishing an alternative to structural separation for the CPE operations of the BOCs. In place of structural separation, we allowed the BOCs to comply with nonstructural safeguards, including the cost allocation rules which we adopt in the instant proceeding. [FN53]

III. GENERAL ISSUES

32. In this Part we address three sets of issues pertaining to the scope of this proceeding: What are the goals and purposes that we hope to further with accounting separation rules? To which carriers should these rules apply? And to which activities of those carriers? We also discuss questions raised by some parties about our authority under the Communications Act to promulgate cost allocation rules for nonregulated activities.

A. Goals and Purposes

33. In the introduction to the NPRM we stated that "the ultimate goal of this proceeding is to ensure that ratepayers in the interstate jurisdiction pay telephone rates that are just and reasonable, as mandated by Section 201(b) of the Communications Act of 1934, as amended." [FN54] We then observed that insuring just and reasonable rates for services that remain subject to regulation requires guarding against cross-subsidy of nonregulated ventures by regulated services, and that cross-subsidy can result either from the misallocation of common costs or from improper intracorporate transfer pricing. [FN55]

1. Comments

34. A number of parties urge us to expand our stated goals. Southwestern Bell, for example, argues that our goals should include encouraging new technologies and services, and that ratepayer concerns should be balanced against this additional purpose. [FN56] Many carriers share this view, although others take the position that cost allocation rules should be neutral, neither stimulating nor deterring carrier entry into new businesses. [FN57] Alabama, on the other hand, admonishes that this Commission has no responsibility whatever toward the viability of nonregulated services. [FN58]

35. Parties representing enhanced service providers, CPE vendors, and other competitors express concern that the NPRM did not sufficiently emphasize protection of competition as a goal. [FN59] CBEMA, for example, suggests that one of our purposes must be to guard against artificially low nonregulated prices; [FN60] while Compuserve states that we should be seeking to prevent AT & T and the BOCs from gaining unfair advantage over "pure" enhanced service providers, [FN61] and Motorola believes we should be trying to establish a level playing field for competition. [FN62]

36. The Consumer Federation of America expresses the view that achieving the lowest possible rates for basic service should be an explicit goal of this proceeding. [FN63] NASUCA argues that we should address not only the allocation of joint and common costs but also allocation of any increases in the cost of capital that may occur as the result of diversification. [FN64] NASUCA and others also advocate expanding the scope of this proceeding to consider whether nonregulated affiliates should be required to compensate ratepayers for benefits derived from intangible assets such as good will. [FN65]

2. Discussion

37. We reaffirm that protecting ratepayers from unjust and unreasonable interstate rates is the primary purpose behind the accounting separation of regulated from nonregulated activities, just as it is the purpose behind all of our accounting and cost allocation rules. Our commitment to cost-based rates demands close attention to the manner in which the costs a company uses to support its interstate and access tariff filings are separated from the other costs of the company.

38. We acknowledge, though, that our statement of our goals in the NPRM may seem unduly narrow, particularly in light of our subsequent determinations in Phase I of the Third Computer Inquiry. The Computer III goal of maximizing the availability to the public of efficient, low-cost telecommunications services of all kinds [FN66] is logically and necessarily conjoined to the previously stated goals of this proceeding.

39. Our determinations in Computer III and in the structural relief proceedings that there may be significant efficiencies in allowing the BOCs and AT & T to integrate their various activities, and that it is in the public interest to allow the carriers to achieve these efficiencies, also remind us that assurance of just and reasonable rates does not stop with assuring that regulated operations do not cross-subsidize nonregulated activities. Rather, if there are savings to be gained from the integration of regulated and nonregulated ventures, those savings must be shared equitably with ratepayers in order to achieve regulated service rates that are just and reasonable. [FN67]

40. While we agree that the rules we adopt here should be suitable for an increasingly

competitive telecommunications environment, we disagree with those parties who intimate that we should design these rules so as to cause the accounting system to produce information that would allow us to determine whether prices for nonregulated products and services are anti-competitively low. The pricing of individual nonregulated products and services does not fall within our statutory mandate. Complaints about predatory pricing in nonregulated markets are the province of the antitrust laws. The proper purpose of our cost allocation rules is to make sure that all of the costs of nonregulated activities are removed from the rate base and allowable expenses for interstate regulated services. It is not our purpose, nor should it be our purpose, to seek to attribute costs to particular nonregulated activities for purposes of establishing a relationship between cost and price.

41. We also decline to expand this proceeding to address allocation of intangible benefits and of increases in the cost of capital which may occur due to carrier diversification. Both of these matters are outside the scope of our NPRM and would be better addressed in separate proceedings or in connection with rate of return prescriptions. [FN68]

B. Applicability to small telephone companies

42. In the NPRM we proposed that cost allocation standards and affiliate transaction rules would apply to all local exchange carriers and dominant interexchange carriers, [FN69] but that only Tier I local exchange carriers [FN70] and dominant interexchange carriers would be required to file cost allocation manuals describing in detail the manner in which they would implement those standards. Because we recognized, however, that many of the proposals in the NPRM were developed with larger telephone companies in mind, we also solicited comment on the extent to which any rules we might adopt in this proceeding should include modifications or exceptions for small telephone companies. [FN71]

1. Comments

43. There is broad support in the comments for some type of relief for small telephone companies. Some parties argue that small companies should be exempt from all federally imposed cost allocation rules because they serve rural areas where there is little demand for nonregulated services, or because they have little ability to shift nonregulated costs to regulated services due to alleged recent shifts of regulated costs from the interstate to the intrastate jurisdiction. [FN72] Granite Telephone, et al., claims that the cost of complying with cost allocation rules for nonregulated activities could be enough to discourage some small companies from offering such services to their customers. US West, on the other hand, urges that we reject the contention that small companies do not or cannot cross-subsidize competitive ventures, but argues in favor of exemption for small companies on the grounds that the burdens imposed by cost allocation rules would outweigh the benefits. Kiesling suggests that regulation of the sort proposed in the NPRM may not be necessary for small companies because the reporting and

audit requirements imposed on many such companies by the REA suffice to guard against abuses. [FN73]

44. Parties take a variety positions on what companies should be considered "small." Several argue that all companies with less than $100 million in revenues should be exempt, not only from filing cost manuals, but from all cost allocation rules, [FN74] while TDS suggests that $50 million in revenues could also be an appropriate cutoff point. [FN75] Others would define "small" in terms of numbers of access lines rather than by revenues. Pennsylvania favors 5000 access lines, [FN76] while several parties suggest 20,000 [FN77] or 50,000 [FN78] lines.

45. Most parties addressing the question of the extent of any exemption simply state that small companies should be exempt from our entire proposal. Granite and OPASTCO elaborate on this contention as follows: this Commission should generally regard all nonregulated activities of small telephone companies as "incidental" for both accounting and cost allocation purposes. There should be no limit on the amount of revenues a small company could earn from such activities; or, if there is a limit, it should be 10 percent of total company revenues, which is the FASB 14 requirement for identification of an activity as a reportable business segment. In addition, they argue, small companies should be permitted to price nonregulated products at short run incremental cost, and any review of their nonregulated activities should be conducted by state commissions in the course of normal review of costing in rate cases. [FN79]

46. Only a few parties reject the concept of an exception for small companies. Two parties who represent nonwireline mobile services providers argue that even the smallest LEC is in a position to subsidize its wireline mobile services and thus to harm its nonwireline competitors. [FN80] One state, Idaho, takes the position that small companies are in need of standards to guide them as they diversify, and that modifications and exceptions should be made by waiver and not by rule.

2. Discussion

47. We are adopting our original proposal to apply our cost allocation standards and affiliate transaction rules to all local exchange and dominant interexchange carriers. However, most of the potentially burdensome enforcement provisions, including the requirement that a cost manual be filed, the requirment of an annual independent audit, and the interim reporting requirements we will establish for purposes of monitoring cost allocations made pursuant to our standards, will apply only to the Tier I LECs and AT & T.

48. We are not convinced that small companies are unable to cross-subsidize their nonregulated activities. Indeed, as noted by US West, these companies are subject neither to line of business restrictions nor to structural separation and thus have been freer than AT & T, the

BOCs, or the GTOCs to commingle their activities. We have no reason to believe that they lack the natural incentive to shift costs, and that their ability to do so has so diminished as to remove all cause for regulatory concern. This being the case, it is our duty to assure that their nonregulated costs do not enter the revenue requirement for interstate services. Also, our determination that the economies of integrated operations should be shared with the regulated ratepayers should in fairness apply to customers of small companies as well as to those of large ones.

49. Furthermore, no party has demonstrated that the existence of cost allocation standards themselves (as distinct from filing and reporting requirements connected with them) is burdensome or expensive. Presumably all telephone companies which engage in nonregulated activities must go through a process of allocating costs in order to isolate the regulated costs they need to support their tariff filings, as well as for internal business management purposes. The argument that they should be allowed to use incremental costing instead of full cost allocation just because they are small is likewise unsupported by any evidence that fully distributed costing is administratively more burdensome or costly than incremental costing. While "incidental" treatment would be considerably less burdensome, we must reject the notion that investments and expenses associated with an activity that earns 9.9 percent of a company's total revenues could be so truly "incidental" that it would not be worthwhile to identify the activity and to exclude the costs from the regulated revenue requirement.

C. Applicability to Specific Types of Activities

1. Introduction

50. Part 31 of our Rules presently classifies as "[n]onregulated activities" all "activities of a subject telephone company which are not common carrier telecommunications products and services subject to the tariff requirements as contained in Title II of the Communications Act of 1934, as amended, and common carrier telecommunications products and services tariffed by state commissions." [FN81] "Regulated" activities, in turn, refer to activities which either are subject to the Title II tariff filing requirements or are common carrier telecommunications products and services tariffed by the state commissions. [FN82] In accordance with the Fifth Report and Order in CC Docket No. 81-893, [FN83] subject carriers may initially record certain costs of nonregulated activities in accounts for regulated operations. [FN84] At the end of each month, however, the carrier must transfer those costs which are recorded in accounts for regulated operations, other than investments in items of common plant, to an asset account, Account 106 (Nonregulated investment). [FN85] Investments in items of common plant remain in the account in which they are initially recorded. In addition, we specified the use of a profit and loss account, Account 317 (Income from nonregulated activities) for recording the net profit or loss from engaging in nonregulated activities on a structurally unseparated basis. [FN86]

51. In the NPRM, we observed that questions had arisen as to the scope of the definition of nonregulated activities adopted in the Implementation Proceeding. [FN87] When read in conjunction with the instructions for Accounts 106 and 317, that definition appeared to require that nontariffed services offered incidental to tariffed services be accorded nonregulated accounting treatment. [FN88] Such treatment of incidental activities was claimed to be inconsistent with Section 31.5-50(a) of our Rules, [FN89] which instructs carriers to include revenues from incidental services in the operating revenue accounts. Similarly, a literal reading of our accounting rules would have required carriers to use Accounts 106 and 317 to account for basic services detariffed by a state, even though this Commission had never considered the implications of such an approach. We observed that the definition of nonregulated activities adopted in the Fifth Report and Order encompasses activities, such as real estate development, which have never been regulated as communication services, as well as traditionally regulated services, such as CENTREX, after they have been deregulated by a state. [FN90]

52. These and other questions persuaded us to conclude tentatively in the NPRM that we should not continue to employ "a single nonregulated accounting scheme automatically invoked by operation of an inclusive definition of ’nonregulated activity.’ " [FN91] In lieu of such a scheme, we proposed to distinguish among five separate types of nonregulated activities: (a) activities which have never been subject to tariff regulation; (b) activities which this Commission has preemptively detariffed; (c) activities which this Commission has detariffed only in the interstate jurisdiction; (d) activities detariffed only in a state jurisdiction; and (e) incidental activities. [FN92]

53. We proposed to require that activities which have never been subject to tariffing and preemptively deregulated activities continue to be treated as nonregulated activities for accounting purposes. Under that approach, the jurisdictional separations process would not apportion the costs of and revenues from such activities between the interstate and the intrastate jurisdictions. [FN93]

54. We also proposed to treat activities detariffed only in the interstate jurisdiction on a case-by-case basis. The NPRM addressed only one such activity specifically, billing and collection service. We tentatively concluded that the costs of and revenues from interstate and intrastate billing and collection service should be recorded in regulated accounts and should not be removed until after the costs and revenues had been apportioned in accordance with jurisdictional separations procedures. [FN94]

55. We presented two alternatives with respect to basic services detariffed by a state. One alternative would make our accounting and cost allocation rules for nonregulated activities inapplicable to such services. That approach would let each state commission determine how the costs of detariffed intrastate services would be identified and removed from the costs the

jurisdictional separations process assigns to intrastate services. The other alternative would be to continue to require each state-detariffed service to be classified as a nonregulated activity, absent a waiver permitting classification of the service as a regulated activity. [FN95]

56. We also proposed to continue to permit incidental activities to be classified as regulated activities for accounting and cost allocation purposes, provided that all such activities are outgrowths of regulated operations and that no more than 0.05 percent of the operating company's total revenues could be classified as incidental activities for three consecutive years. [FN96] We proposed that treatment, because we had tentatively concluded that activities meeting the specified criteria would pose so little threat of harm from cross subsidization that the costs of classifying such activities as nonregulated activities for accounting purposes would exceed the benefits. [FN97]

2. Comments

57. a. In general. Although the parties generally agree that we should promulgate a new standard for determining which activities should be classified as nonregulated activities, the views of the parties vary considerably as to what that new standard should be. That disagreement focuses on the effect nonregulated accounting treatment might have on the jurisdictional separations process. As a number of parties recognize, if according nonregulated accounting treatment to an activity means that the costs of that activity will be excluded from the costs apportioned in the jurisdictional separations process, then the choice of accounting treatment may affect the apportionment of costs and revenues between the interstate and intrastate jurisdictions. [FN98]

58. The parties have provided no quantitative information regarding either the magnitude or the direction of potential jurisdictional shifts. Some parties suggest that subjecting all common costs to the jurisdictional separations process would minimize the potential for jurisdictional shifts. [FN99] At least one of those parties acknowledges, however, that the extent of the potential shifts is dependent on a variety of factors, including the nature of and treatment accorded to each service being addressed in this proceeding. [FN100] Other parties maintain that this Commission should address any concerns which the removal of interjurisdictional subsidies may raise in a separate proceeding to review and revise the jurisdictional separations rules. [FN101] According to those parties, this Commission should not use cost allocation rules to perpetuate those subsidies. [FN102]

59. b. Activities which were never subject to tariffing and preemptively deregulated activities. The parties addressing these activities generally agree that these activities should be classified as nonregulated activities. [FN103] While few parties explain their positions regarding these activities, US West states that the costs of preemptively detariffed activities must be

removed from regulation prior to jurisdictional separations to keep those costs from being assigned to access rate elements under Part 69 of our Rules. [FN104] PacTel indicates that some activities which have never been subject to tariffing are an outgrowth of regulated activities and should be treated as incidental activities. [FN105] PacTel proposes that we distinguish between nontariffed, line-of-business activities, which would be classified as nonregulated activities, and nontariffed, non-line-of-business (i.e., incidental) activities, which would be classified as regulated activities. [FN106] In addition, several states suggest that, as a consequence of Louisiana Public Service Commission, the group of activities classified as preemptively deregulated activities may be smaller than previously thought. [FN107]

60. c. Activities detariffed in only one jurisdiction. Many parties also favor according nonregulated accounting treatment to activities detariffed only in the interstate jurisdiction and to activities detariffed only in a state jurisdiction. [FN108] Those parties maintain that this Commission should divide all costs between regulated and nonregulated activities prior to jurisdictional separations in order to confine the separations process to its intended role of apportioning regulated costs between jurisdictions, and to avoid incorporating the inaccuracies inherent in the jurisdictional separations process into the cost accounting process. [FN109] It is claimed that dividing costs between regulated and nonregulated services prior to jurisdictional separations would permit easier extraction of the costs related to particular services, [FN110] and that the subjective rules applied in jurisdictional separations must not be permitted to influence cost-of-service allocations. [FN111] AT & T maintains that tariffed activities for which rate-of-return regulation has been streamlined, forborne, or otherwise relaxed should be classified as nonregulated activities and that the costs of such activities should not be apportioned in the jurisdictional separations process. [FN112] In addition, AT & T indicates that the goal of preventing cost shifting between activities cannot be met if carriers classify nontariffed services as regulated activities. [FN113] ADAPSO contends that activities detariffed in one jurisdiction should be accorded nonregulated accounting treatment, because this Commission should not rely on its accounting and cost allocation rules to ameliorate the effects of ill-advised deregulation. [FN114]

61. Other parties argue that activities detariffed in only one jurisdiction should be classified as regulated activities. US West maintains that it is appropriate to examine services detariffed only in the interstate jurisdiction on a case-by-case basis and that there is no need for this Commission to deviate from the normal jurisdictional separations process when a state deregulates or detariffs intrastate services. [FN115] PacTel states that it does not have accounting processes in place to recognize the effects of services detariffed in only one jurisdiction. Therefore, PacTel proposes to classify such activities as regulated activities and to use the jurisdictional separations process to apportion their costs between the interstate and intrastate jurisdictions. [FN116] Rochester suggests that small independent companies should be allowed to classify all deregulated activities as incidental activities. [FN117]

62. Although Ameritech advocates a uniform rule under which jurisdictional separations would apply only to costs subject to Title II regulation and only after all costs have been apportioned between regulated and nonregulated services, [FN118] Ameritech also suggests that network services which have been deregulated by a state should be classified as regulated activities. [FN119] In Ameritech's view, there are several compelling reasons for that treatment. First, Ameritech indicates that variations in the form and scope of state deregulation would require a myriad of revised Separations Manual provisions, if state-deregulated network services were to be classified as nonregulated activities. [FN120] Second, Ameritech argues that allowing states to decide what costs would be apportioned through the jurisdictional separations process could compromise certain federal policies, apparently by eliminating the jurisdictional basis for those policies. [FN121] Finally, Ameritech suggests that disputes regarding the definition of "deregulated" would create an administrative nightmare. [FN122] It questions whether services, which are subject to state commission scrutiny despite being provided pursuant to contract, would be classified as "deregulated" services. [FN123]

63. The states generally support dividing the costs of activities detariffed in one jurisdiction between regulated and nonregulated activities after the jurisdictional separations process. Arkansas argues that using that approach for billing and collection and other services detariffed only in the interstate jurisdiction would minimize, but not eliminate, the potential for jurisdictional shifts. [FN124] Pennsylvania, however, is concerned that isolating billing and collection costs after jurisdictional separations may burden intrastate operations with excess investment. [FN125] According to Idaho, regulated accounting treatment is appropriate when states detariff services without relinquishing all control of them or of the associated costs and revenues. [FN126] The Florida PSC expressly objects to the case-by-case waiver approach and supports a system which would allow each state to determine how the costs of detariffed intrastate services should be identified and treated. [FN127]

64. US Sprint argues that the appropriate test for determining the accounting treatment to be accorded a particular activity is not merely whether the service is tariffed at the federal or state level, but whether the activity is a common carrier communication service within the ambit of Title II. [FN128] US Sprint argues that this Commission has a continuing obligation to ensure that services that are subject to regulation should not be the means of cross subsidization of activities not subject to regulation, whether or not forbearance has been extended to the services. [FN129] Under that test, activities such as billing and collection services, which this Commission has determined to be noncommunication services, would be classified as nonregulated activities. [FN130] Basic services detariffed by the states would continue to be classified as regulated activities. [FN131]

65. NATA believes that the costs of services deregulated only in the interstate jurisdiction should be removed from regulated accounts prior to jurisdictional separations to avoid disputes over whether costs are being removed twice from the interstate revenue requirements. [FN132]

NATA argues, however, that state deregulation should not affect the separations treatment accorded basic services whose costs have been attributed to interstate access services. In NATA's view, costs should be removed from a carrier's interstate revenue requirement only if it has been determined that (a) the costs belong in the intrastate jurisdiction; (b) the costs should be disallowed for ratemaking purposes; or (c) the relevant interstate service should be deregulated. [FN133] NATA asserts that none of those determinations follow logically from the deregulation of a service by a particular state. [FN134]

66. d. Incidental activities. While the parties agree that we should continue to allow at least some nontariffed activities that are incidental to tariffed services to be classified as regulated activities, there is widespread disagreement as to the standard to be applied in determining when an activity is an incidental activity. The carriers commenting on the matter find our proposal that no more than 0.05 percent of an operating company's total revenues could be classified as incidental activities for three consecutive years far too restrictive. [FN135] Some carriers propose caps as high as 5.0 percent of total revenues. [FN136] Others propose that revenue-based caps of 0.5 percent or higher be applied to each discrete incidental activity rather than to all incidental activities as a group. [FN137] USTA states that the cap for small LECs should be the higher of 10.0 percent of gross revenues or $1.0 million. [FN138]

67. Certain carriers contend that we should use a definitional rather than a quantitative approach to identify incidental activities. [FN139] PacTel proposes a definition which would treat an activity as an incidental activity if and only if it (a) is an outgrowth of regulated operations; (b) cannot be identified as a line of business; (c) occurs infrequently; and (d) does not cause any material increase in costs. [FN140] Under the GTOCs' definition, no activity significantly increasing either new investment, the use of existing resources, or the business risks of the regulated operation would be considered an incidental activity. [FN141] SNET would focus on whether the company has to commit resources to engage in the activity and would not classify any activity which creates a risk of failure as an incidental activity. [FN142]

68. Several parties suggest that the BOCs are attempting to insulate large sums from the cost allocation process by defining incidental activity expansively. [FN143] According to those parties, a 3.0 percent revenue-based cap would exclude between 50.0 percent and 60.0 percent of the BOCs' total revenue from nonregulated activities from the cost allocation process. [FN144] Certain parties argue that any revenue-based cap would be ineffective because it would not keep carriers from burdening ratepayers with the initial losses associated with start-up ventures. [FN145] NATA argues that a carrier could evade any revenue-based cap by giving "incidental" products and services away to promote the sale of competitive network products such as Centrex. To prevent that from occurring, NATA proposes use of both cost-based and revenue- based caps.

In addition, NATA would permit an activity to be classified as an incidental activity only if we

have found that the activity presents minimal potential for adverse effects on ratepayers and competitive markets. [FN146]

3. Discussion

69. a. Framework for determining which types of activities should be classified as nonregulated activities. The rules adopted in the Fifth Report and Order, when read literally, extend nonregulated accounting treatment to all services which are not either subject to tariffing under Title II of the Communications Act or actually tariffed as common carrier telecommunications products and services by a state commission. [FN147] We confirm our tentative conclusion that those rules do not describe a nonregulated category that is appropriate for our purposes. We believe that rules which are narrowly tailored to further our objective of determining the costs of interstate common carrier communication services will keep regulated common carriers from using the revenues from their regulated services to subsidize nonregulated enterprises and will ensure that ratepayers receive their appropriate share of the benefits arising from the offering of regulated and nonregulated services on a structurally unseparated basis.

70. We have decided that the accounting classification should be related to the scope of regulation under Title II of the Communications Act. All activities that are classified as common carrier communications for Title II purposes will be classified as regulated activities for purposes of our accounting rules and nonregulated activity cost allocation rules. Most activities that are not classified as common carrier communications services for Title II purposes will be classified as nonregulated activities.

71. The scope of Title II regulation is not always synonymous with a tariffed offering. We have sometimes decided to forbear from requiring tariff filing even though the person who offers the service is subject to statutory duties imposed by Sections 201 and 202 of the Act and other persons can invoke Section 208 complaint remedies to enforce those duties. [FN148] Although we have not applied that forbearance policy to any persons who are subject to the USOA, such persons should note that any common carrier offerings that might be subject to forbearance in the future would still be classified as regulated activities for purposes of our accounting rules. Tariffed services that are subject to streamlining or some other form of decreased regulation would also be classified as regulated activities. Although it will probably be necessary to develop cost allocation rules to segregate costs attributable to streamlined activities from other regulated activity costs, we have decided not to adopt the AT & T suggestion that we develop such allocation rules in this docket. Any attempt to do so would unduly complicate our present task.

72. If an activity is classified as a common carrier communication service for Title II purposes, then both interstate offerings that are regulated pursuant to Title II and intrastate offerings that are not subject to federal regulation will be classified as regulated activities for

purposes of our accounting and cost allocation rules. All of these activities will also be classified as regulated operations for purposes of the Part 67 jurisdictional separations rules.

73. b. Treatment of state-deregulated basic services. Virtually all parties appear to agree that regulated accounting treatment is appropriate if the offerings are actually tariffed with this Commission and a state commission. The consensus does not extend to activities that are reflected in interstate tariffed offerings and that are detariffed or otherwise subjected to some form of deregulation in one or more states. A literal interpretation of our present rules would classify the activity, or at least the intrastate portion of the activity, as a nonregulated activity. The rules that we are adopting in this Report and Order will classify the entire activity as a regulated activity.

74. We believe that the benefits to be derived from classifying state- deregulated basic services as regulated activities far exceed those from any alternative approach. We agree with Ameritech's observation that disputes regarding the definition of deregulated would create an administrative nightmare for this Commission in the event we were to require that state-deregulated basic services be classified as nonregulated activities. We have no desire to superintend the deregulatory actions of state commissions, and we will not burden the cost allocation manual review process with proceedings to determine whether changes in the form of state regulation are sufficient to warrant according nonregulated accounting treatment to traditionally regulated activities.

75. Moreover, we discern no federal benefit to be derived from requiring that state-deregulated basic services be classified as nonregulated activities. Although such treatment would prevent changes in demand for nonregulated services from changing interexchange costs, we are aware of no case holding that such a demand-cost relationship renders rates based on those costs inherently unreasonable. More significantly, a standard for determining when a service is deregulated would have to accompany any requirement that state- deregulated basic services be classified as nonregulated activities. The record in this proceeding is not sufficient to enable us to promulgate such a standard.

76. c. Treatment of incidental activities. Most parties apparently also agree that non-incidental activities that have never been tariffed or otherwise regulated by this Commission or any state commission should be classified as nonregulated activities. This consensus also apparently extends to activities such as the provision of CPE that have been preemptively deregulated. Any controversy over the treatment of activities which are not common carrier communications services appears to be limited to the nature and scope of any incidental activity exception and to the treatment of activities such as the provision of billing and collection services for other carriers that this Commission has deregulated without totally preempting state regulation.

77. In the NPRM, we proposed to continue to permit carriers to account for nontariffed activities offered incidental to tariffed services as regulated activities, provided the activities are outgrowths of regulated operations and the revenues from those activities do not exceed a particular percentage of the accounting carrier's total revenues for three consecutive years. The vast majority of the parties commenting on this matter favor some allowance for incidental activities, and we agree that carriers can be allowed to classify at least some incidental activities as regulated activities without distorting the ratemaking process. However, since incidental activities are not subject to tariff regulation, we are concerned that an exception permitting incidental activities to be classified as regulated activities may undermine our decision that nonregulated accounting is generally appropriate for activities that are not common carrier communications services. We have determined that the danger that incidental accounting will subvert our cost allocation rules will be minimized if we allow incidental treatment of activities which produce, in the aggregate, no more than one percent of a company's total revenues.

78. In addition, we are persuaded that limiting the magnitude of such an exception solely on the basis of total revenues from regulated activities would inadequately protect ratepayers. As several parties have observed, underpricing products and services during the formative years of an unregulated activity would enable carriers to evade any such limitation. Although we could specify that no more than a given percentage of a carrier's total regulated costs could be attributable to incidental activities, the record in this proceeding provides us with no concrete information as to what that percentage should be. Instead, we shall adopt the suggestion made by anumber of parties that we should apply qualitative guidelines as well as quantitative limits in determining which activities may be accounted for as incidental. We will apply these qualitative guidelines at the manual-review stage. Carriers will specify in their initial cost allocation manuals precisely which activities they propose to treat as incidental activities. Since it would be unreasonable to require interstate ratepayers to support any activity, which constitutes a separate line of business, but which is not itself a common carrier communication product or service, we will permit only non-line-of-business activities to be treated as incidental activities. [FN149] Moreover, to prevent carriers from classifying an activity as an incidental activity as a means of evading our requirement that activities which are not subject to tariffing as common carrier communication services generally be accorded nonregulated accounting treatment, we will not approve the treatment of any activity as an incidental activity which the carrier in question has not traditionally treated in that way. Each cost allocation manual filed with this Commission should include a showing that any activity proposed for treatment as an incidental activity meets the above guidelines.

79. d. Treatment of activities deregulated only in the interstate jurisdiction. We are not prepared to specify at this time the accounting treatment to be accorded every activity which we might deregulate at the interstate level without preempting all state regulation. Despite suggestions from certain parties that we must require that such activities be classified as nonregulated activities, the practical import of any decision to classify an activity as a

nonregulated activity would be to place the costs of and revenues from that activity outside of the jurisdictional separations process. We believe it best to address such matters in the context of particular activities which we may deregulate in the interstate jurisdiction. Accordingly, we will implement our proposal to address questions regarding the accounting treatment to be accorded such activities on a case-by-case basis. To avoid future confusion, we will require that activities deregulated at the interstate level that are not preemptively deregulated, be classified as regulated activities until such time as this Commission decides otherwise. [FN150]

80. In the Billing and Collection Detariffing Order, [FN151] we determined that the provision of billing and collection service for interexchange carriers is not a common carrier communications service subject to regulation under Title II of the Act. We declined to exercise our Title I jurisdiction over that service because it is sufficiently competitive to keep exchange carriers from charging unreasonable rates for or imposing unreasonable conditions in the provision of that service. Despite those determinations, we did not preempt all state regulation of billing and collection service. [FN152]

81. We believe that billing and collection activities should continue to be accorded regulated accounting treatment. The arguments against that treatment implicitly assume that the jurisdictional separations process results in a misallocation of total billing and collection costs between the interstate and the intrastate jurisdictions. We are not convinced of the accuracy of that assumption. Indeed, it appears equally likely on this record that according nonregulated accounting treatment to billing and collection costs would result in an understatement of interstate costs. In these circumstances, it is appropriate to require subject carriers to continue to classify billing and collection as a regulated activity until such time as it is shown that such accounting treatment misallocates costs between the jurisdictions. We will continue to use our Part 69 rules to remove costs attributable to interstate billing and collection from access elements and the LEC interexchange category.

D. Authority under the Communications Act

1. Introduction

82. In the NPRM, we indicated that we would be relying on Sections 4(i), 201(b), 218, 219, and 220(a) of the Communications Act of 1934, as amended, [FN153] in promulgating rules in this proceeding. [FN154] Those provisions give this Commission extensive jurisdiction to enforce the requirement that the rates for interstate common carrier communications services be just and reasonable, [FN155] to obtain information from all subject carriers "and from persons directly or indirectly controlling or controlled by, or under direct or indirect common control with" such carriers," [FN156] and to "prescribe the forms of any and all accounts, records, and memoranda to be kept by [such] carriers." [FN157]

2. Comments

83. The state commissions commenting on the scope of our statutory authority contend that Section 2(b)(1) of the Act [FN158] precludes this Commission from requiring state regulators to use FCC-prescribed cost allocation methods for intrastate ratemaking purposes. [FN159] Those states assert that in Louisiana Public Service Commission v. FCC, [FN160] the Supreme Court construed Section 2(b)(1) as prohibiting FCC preemption of state regulation of intrastate telephone services if compliance with both federal and state requirements is possible. [FN161] Particular states argue that federal and state regulators may reach different conclusions regarding particular cost allocation matters, [FN162] that any regulations promulgated in this proceeding must be narrowly tailored to avoid interfering with the states' regulatory authority over intrastate matters, [FN163] and that we should provide for ongoing input from states to minimize interjurisdictional disparities in cost allocation and accounting methods. [FN164] Several states suggest joint federal-state efforts to develop uniform cost allocation rules which would be applicable in all jurisdictions. [FN165] Those efforts, we are told, should take the form of a formal Federal-State Joint Board, [FN166] an informal working group similar to a Joint Board, [FN167] or a series of periodic meetings involving this Commission, the state commissions, and the telephone companies. [FN168]

84. Other parties also argue that this Commission lacks the authority to compel the states to adhere to national cost allocation rules and that state regulatory commissions may develop their own cost allocation rules for carriers' intrastate operations. [FN169] Those parties, however, differ in the conclusions they draw from that asserted lack of authority. NATA, for instance, believes that one consequence of Louisiana Public Service Commission is that this Commission will be unable to promulgate cost allocation rules that will work. Therefore, NATA suggests that this Commission should condition the elimination of structural separation for any given carrier on that carrier's agreeing to observe our cost allocation rules in all jurisdictions. [FN170]

85. Various parties suggest that federal and state regulators should work together to develop a consistent set of state and federal cost allocation rules. [FN171] BellSouth states that inconsistent state and federal standards may result in the improper exclusion of some costs of regulated activities from all regulated accounts. BellSouth claims that it might have to prepare and use ten cost manuals--one for the interstate jurisdiction and one for each of the nine states in which BellSouth operates. [FN172] US Sprint describes the questions raised by the states as "not insubstantial" [FN173] and suggests that either a Joint Board or an informal federal-state working group may represent the best solution to what US Sprint believes is as much a political problem as a jurisdictional issue. [FN174] NASUCA suggests that jurisdictional separations should precede the allocation of costs between regulated and nonregulated activities. It says this is necessary to avoid forcing the states to base intrastate rates on our cost allocation rules. [FN175]

86. AT & T maintains that Louisiana Public Service Commission supports this Commission's authority to prescribe accounting rules for segregating regulated and nonregulated operations. According to AT & T, that opinion "expressly recognized that the Communications Act gives the Commission the authority to determine in the first instance 'what portion of an asset [or other cost] is employed to produce or deliver interstate as opposed to intrastate service.' " [FN176] AT & T views the prescription of accounting rules for all of a carrier's nonregulated activities as a necessary part of determining what portion of a carrier's costs is used to provide interstate service. [FN177]

87. Southwestern Bell suggests that deferral of a decision in this proceeding pending Joint Board action or the completion of a series of three-way meetings might not serve the public interest. In Southwestern Bell's view, delay in implementation of cost allocation rules could have debilitating effects on the ability of LECs to offer several major services which are to be deregulated on January 1, 1987. However, Southwestern Bell states that it could be desirable to convene a Joint Board to adjust jurisdictional separations methods once the rules being promulgated in this proceeding have been implemented. [FN178]

3. Discussion

88. Comments with respect to the possible impact on this proceeding of Louisiana Public Service Commission are based upon a misinterpretation of the NPRM. We did not propose to require state commissions to use our cost allocation procedures to segregate costs between intrastate regulated activities and nonregulated activities. Such uniformity is likely to be impossible because the scope of regulation is beginning to diverge in various jurisdictions. Some states may choose to regulate some activities that this Commission does not regulate. Others may choose to deregulate activities that would be classified as common carrier communications services for purposes of Title II of the Communications Act. In these circumstances, it would be impossible to devise a single cost allocation scheme that fits each state. Accordingly, we did not propose to require states to use our procedures for intrastate ratemaking purposes, and we do not adopt suggestions in some comments that we follow such a course. Inasmuch as we have decided that preemption would not be desirable, there is no reason to determine whether the Supreme Court's recent interpretation of Section 2(b)(1) of the Act would preclude us from giving these rules preemptive effect.

89. There is also no reason to convene a Joint Board or to use alternative consultative mechanisms in order to attempt to achieve uniformity. Because of differences in the scope of regulation, such uniformity no longer appears to be possible. We also decline to adopt the NATA suggestion that we condition removal of structural separation requirements upon a carrier's agreeing to observe our cost allocation rules in all jurisdictions. That proposal is clearly unworkable.

90. Although the states will not be required to use our procedures for intrastate ratemaking, those rules may form a useful guide for those states electing to follow a regulatory approach similar to our own approach. Those rules and the cost allocation manuals that will be developed to implement those rules will be used to develop the core books of account kept by carriers. The costs recorded in those accounts will be apportioned between the interstate and intrastate spheres in the jurisdictional separation process. Consequently, state regulators will have the product of our efforts available for use in intrastate ratemaking. The states will be free to employ different cost allocation methods and affiliate transaction rules in intrastate ratemaking, and to mandate that carriers keep any side records required for the states' regulatory purposes.

91. Despite the states' ability to use their own procedures for intrastate ratemaking, our procedures will be used to identify the regulated investment, expenses and revenues that will be apportioned pursuant to the Part 67 jurisdictional separations rules. This does not mean that states will be required to use the resulting "intrastate regulated" costs for ratemaking purposes. The states can reallocate costs between the intrastate regulated and nonregulated spheres in order to reflect the scope of regulation in a particular state. [FN179] This procedure is fully consistent with Section 410(c) of the Act. That section requires this Commission to "refer any proceeding regarding the jurisdictional separation of common carrier property and expenses between interstate and intrastate operations" and allows us to refer "any other matter, relating to common carrier communications of joint Federal-State concern," to a Federal-State Joint Board for a recommended decision. [FN180] We interpret the phrase, "common carrier property and expenses," in Section 410(c) to be synonymous with investment and expenses attributable to common carrier communication services. Since we have required that nonregulated accounting treatment be accorded only to activities which are not common carrier communication services, [FN181] it is not necessary that we convene a Joint Board pursuant to Section 410(c). [FN182] Congress could not have intended that carriers go through the complex process of separating costs of "operations" into their interstate and intrastate components when none of those those costs can be recovered in interstate rates. [FN183]

92. We also reject the notion that we must convene a Joint Board to determine whether the rules we are promulgating will cause jurisdictional shifts as they remove costs not attributable to common carrier communication services from regulated accounts. The rules we are adopting will not be likely to have a substantial effect upon jurisdictional separations results in the absence of a decision to deregulate additional activities at the federal level. Of course, should it appear in the course of our review and approval of carriers' cost allocation manuals that significant jurisdictional shifts will occur, we can at that time refer any problem areas to a Joint Board.

93. We recognize that many of the parties which request that we refer this proceeding to a Joint Board are asking us to rely on our discretionary power to refer "matter[s], relating to common carrier communications of joint Federal-State concern," to a Joint Board. [FN184] We must decline those requests as well as the requests that we defer this proceeding to obtain

additional input from interested parties. The record in this proceeding is sufficient for us to specify the principles that carriers are to apply in preparing their cost allocation manuals, and we do not believe that obtaining additional comment would materially aid our efforts to specify those principles.

IV. COST ALLOCATION STANDARDS

A. Fully Allocated Costing

1. Introduction

94. Historically, debate over cost allocation methodologies in Commission proceedings has tended to focus upon the relative merits of fully allocated and incremental costing methodologies. We have traditionally used fully allocated costing in dividing the costs of regulated telephone service between the state and interstate jurisdictions [FN185] and in distributing the interstate costs of local exchange carriers among the access elements and the interexchange category. [FN186] Full allocation is also the principle behind the current method whereby we divide AT & T's interstate costs among the broad categories of the company's interstate services. [FN187] We have, to a limited extent, allowed use of incremental costing approaches in pricing certain of AT & T's regulated services. [FN188]

95. A fully allocated costing system divides the entire cost of a group of products among those products through direct assignment or by some allocation factor. The allocation factor does not necessarily reflect the costs caused by any particular service. An incremental costing system measures the additional cost created by the production of one particular product, given a set of other products that are being produced. The sum of incremental costs for all products considered may not represent the total cost of producing those products. The incremental cost of any particular product necessarily depends upon the other set of products being produced. The following example has been used to illustrate this interdependence:

> Imagine a railroad that provides mainline service for a wide range of commodities and, in addition, has a spur line that carries only coal and iron ore, each carried on separate trains.... [T]he incremental cost of the coal service includes none of the roadbed cost of the spur line, because that line would have had to be built and maintained just to transport the iron ore. Similarly, the incremental cost of the iron ore service also includes none of the roadbed cost of the spur line. So, if the two services were to contribute revenue just sufficient to pay for its own incremental cost, nothing would be available to finance replacement and maintenance of the spur, and it would make little sense to describe that set of rates as compensatory.

Consequently, in addition to testing the coal and iron ore services separately, it is

necessary to test the two together to see whether their combined revenues cover the incremental cost of producing them both. This incremental cost figure does include the entire cost of the spur line, because in our example, the spur would be unnecessary in the absence of the coal and iron ore services (emphasis in original). [FN189]

96. In the NPRM we proposed to continue our long-standing requirement of fully allocated costing for the apportionment of costs between regulated and nonregulated activities. We indicated that exceptions might be considered on a case-by-case basis. [FN190]

2. Comments

97. The BOCs take positions on this issue ranging from strong advocacy of incremental costing to qualified support of fully allocated, or fully distributed, costing. [FN191] Proponents of incremental approaches argue that full allocation of costs arbitrarily assigns costs to nonregulated activities regardless of whether the nonregulated activity caused the costs. They cite case law and academic authority for the proposition that FDC is not required to prevent cross-subsidy and that the legal test applied by some courts in cases involving communications common carriers has been whether the service covers its marginal costs. BellSouth submits a paper purporting to demonstrate that marginal costing would promote efficient utilization of the network, prevent cross-subsidy, and promote competition. [FN192] Several companies cite the line of antitrust cases applying the Areeda-Turner test for predation as support for use of incremental costing. [FN193] Companies also draw support for incremental costing from our statements in the Private Line Rates Guidelines and MTS Guidelines [FN194] orders. They note that we discussed these departures from strict FDC with apparent approval in the NPRM in this proceeding.

98. BOCs express concern that use of FDC would require them to forego offering a service if its market price is less than the costs that would be assigned to that product by fully distributed costing yet greater than the long-run incremental costs of offering that service. The companies argue that FDC would thus deprive the ratepayers of any contribution to overhead that could have been made by such a service. They point to interstate billing and collection as a concrete example of just such a situation and imply that billing and collection is probably not unique.

99. Several BOCs take the position that, while full distribution of costs is uneconomic and arbitrary, it is reasonable to expect some level of contribution to the overheads of the firm from nonregulated activities. They propose various means of assessing this contribution. Ameritech proposes that, after all directly assignable and causally attributable costs have been assigned to nonregulated activities, a contribution amount would be calculated for the nonregulated sector of the company as a whole; overhead would not, however, be attributed specifically to individual services. [FN195] Bell Atlantic argues that incremental costing in

combination with above-the-line accounting treatment for all nonregulated services would automatically result in each nonregulated service contributing to overhead as the marketplace permits. Services which could be sold well above incremental cost would make a large contribution while services which are subject to intense competition might make little or no contribution. [FN196] US West also asserts that the market place should determine the level of contribution that a particular service can be expected to make to the firm, but does not suggest a mechanism for implementing this approach. [FN197]

100. Southwestern Bell asserts its objection to use of fully distributed costing for pricing purposes, but states that it has filed a manual proposing fully distributed costing because it believes that is what we want to see. [FN198] Pacific Telesis takes the position that long run incremental costing would be adequate to protect both ratepayers and competitors but that FDC is acceptable as a means of providing the additional public interest benefit of sharing fixed costs with the ratepayers. [FN199]

101. All BOCs believe that, if we adopt fully distributed costing, we should provide exceptions. They express concern, however, that a waiver approach might be dilatory and unworkable. BellSouth suggests that, in order to avoid delays, we employ a process whereby the company proposes services for alternative treatment and this Commission rejects the proposal only if we find it inappropriate. [FN200]

102. The ITCs exhibit an even greater range of views than the BOCs. Centel, for example, states that incremental costing may be theoretically correct but that only FDC is feasible. [FN201] Centel also believes that FDC methods are ultimately less intrusive than incremental methods because FDC leaves less room for judgment calls by the company and correspondingly less room for regulatory questioning of the company's judgment. Contel and the GTOCs, on the other hand, strongly oppose use of FDC. The GTOCs argue that, unless this Commission is able to state a more convincing rationale for FDC than it has to date, and unless we engage in a more extensive identification and evaluation of alternatives than we did in the NPRM, a decision in favor of FDC would be "arbitrary and capricious" within the meaning of the Administrative Procedures Act. [FN202] They believe that the net revenue standard used for evaluating Optional Calling Plan tariffs should be equally applicable to the LECs. They present an analysis of predatory pricing cases in support of their position. [FN203] SNET states that FDC should be used for integrated operating and marketing services, but that it is wholly inappropriate for billing and collection services. [FN204] TDS argues that FDC is particularly inappropriate for small companies because they make their decisions to enter or remain in nonregulated ventures based on incremental cost and revenue analysis and not on the basis of fully distributed costs. [FN205]

103. Arthur Andersen also opposes using FDC to allocate costs to nonregulated services. It argues that long run incremental costing, done properly, does allocate common and overhead

costs to nonregulated services; but that, in contradistinction to FDC, it allocates those costs based on cost causation and not arbitrarily.

104. Virtually all other parties commenting upon the issue favor fully allocated costing. AT & T argues that FDC is appropriate because common costs and overheads benefit both regulated and nonregulated activities; because an incremental approach would violate generally accepted cost accounting principles for the allocation of costs between business segments; and because no persuasive reason has been advanced for departing from precedent established under the Computer II regime. AT & T opposes allowing any exceptions to FDC costing, and particularly opposes allowing incremental costing of billing and collection services. AT & T maintains that, if billing and collection service is currently being assigned excessive costs, that is not evidence that FDC methodologies cannot produce appropriate cost allocations; it means only that Parts 67 and 69 apportion excess costs to that activity. AT & T agrees with the BOCs and ITCs that incremental costs are the relevant costs to consider for pricing purposes, but draws a clear distinction between allocation of costs to the nonregulated sector of a company and the establishment of prices for particular nonregulated services. [FN206]

105. The Department of Justice states that, while cross subsidy is avoided as long as all incremental costs are assigned, assignment of residual costs is also important to promote consumer welfare. DOJ argues that there is no sound economic reason to require all residual costs to be born by the regulated sector of the business; that allocation of residual costs is necessary to compensate for inevitable errors in the assignment of incremental costs; and that allocation of overhead is consistent with normal business practice. [FN207]

106. OCCs, enhanced services providers, and CPE vendors all strongly favor fully allocated costing. They argue that the alleged inefficiencies of FDC pricing are irrelevant to the question whether FDC should be used for cost allocations, and that this Commission's departures from FDC for the pricing of some services within the regulated sector are either inapposite [FN208] or wrong. [FN209] They contend that incremental costing is difficult to audit, destructive of carrier accountability, and harmful to competitors who do not have a similar ability to impose all of their overheads on someone else. Several argue that, if a service cannot cover its fully distributed share of overheads, then the service should not be provided. [FN210] They observe that competitive companies offering only nonregulated services must cover all of their overheads through those nonregulated offerings. DEC posits that allocation of common overheads to nonregulated services may provide carriers with an incentive to reduce overhead costs generally. [FN211]

107. State commissions that address the issue favor fully distributed costing. Missouri explains that, while it does find long run incremental cost analysis useful as a starting point in setting the rates for regulated services [FN212] it does not regard incremental costing as acceptable for common cost allocations between regulated and nonregulated activities. Kentucky

expresses concern that we did not indicate clearly who would bear the burden of proof if exceptions were permitted to FDC, while Michigan argues that exceptions should be allowed only if approved by both the state commission and this Commission.

108. Several parties contend that traditional fully distributed costing may not go far enough in assigning costs to regulated activities, and that the best approach would be to base cost allocations on the stand-alone costs of each activity. RCA, for example, argues that full distribution of embedded historical cost fails to share with the ratepayers the savings experienced by the nonregulated activity when the nonregulated activity shares existing equipment instead of buying new equipment. [FN213]

3. Discussion

109. We affirm our intention stated in the NPRM to build our cost allocation scheme upon the premise of full allocation of costs. The reason for this is not that we deem full allocation to be synonymous with prevention of cross- subsidy. In fact, we do not entirely disagree with the parties who observe that cross subsidy could, in theory, be avoided when all of the long run incremental costs of an activity are borne by that activity. [FN214] However, we also agree with DOJ and others who argue that our purposes should transcend prevention of cross-subsidy. Our goal of just and reasonable treatment of ratepayers requires that ratepayers participate in the economies of scale and scope which we believe can be achieved through integration of nonregulated enhanced services within the basic service network. It would not be just and reasonable to allow all of those economies to belong to the nonregulated activities. We also agree with DOJ that there is no good reason why all residual costs of the company should fall to the regulated sector. By the same token, we also disagree with the consumer advocates who seem to argue that all residual costs should fall upon nonregulated sectors. We are seeking to promote an equitable sharing of common costs; but we would not think it proper to attempt through cost allocation rules to arrange a subsidy for regulated activities. [FN215]

110. By adopting a fully allocated cost approach we do not express agreement with those who believe that anything short of full allocation is by definition anti-competitive. We believe that competitors in nonregulated markets must rely for protection on the antitrust laws and the standards which apply in the antitrust arena.

111. Our general goal is to choose rules that cause regulated markets to produce results as close as possible to the results of unregulated markets that are subject to a high degree of competition. In a complex multiproduct environment such as telecommunications, which is subject to economies of scale and economies of scope, [FN216] determining the cost allocations that should result from competition is very complex. There is no single market based allocation, but rather a set of potential allocations determined by the interrelationships among both the cost characteristics and the demand characteristics of the products involved. Economist W.W.

Sharkey summarized the competitive cost allocation problem as follows:

> [T]here are conditions on costs and demands which guarantee the existence of at least one subsidy-free pricing regime. It should be remembered, however, that subsidy-free prices will in general require complicated multipart tariff structures. Also, since a subsidy-free price structure depends on both cost and demand conditions, there is no easy way for a firm or a regulator to determine whether a given set of prices is subsidy free. [FN217]

112. The complexity of discovering true welfare-maximizing cost allocations in a contestable market environment [FN218] requires that simplified proxies for the market-induced allocation be used. Neither incremental costs nor fully distributed costs will meet all of the conditions required for maximum economic efficiency. We have chosen a particular method of forward-looking fully distributed costs that balances the desire for efficiency enhancing cost allocations with the practical requirements of basing decisions on data that can be provided by the carriers and audited by this Commission.

113. The principal methodology we are adopting here is known in the economics literature as an attributable cost method of fully distributing costs. It allocates overhead costs in proportion to the costs that can be directly attributed to various services. Such a method closely approximates an economically efficient method if the elasticity of demand for the various outputs is not too dissimilar. [FN219]

114. Our goals of choosing an economically efficient cost allocation methodology and of choosing a methodology that can be feasibly implemented and audited are somewhat in conflict. Simpler methodologies than the one we are choosing exist, but they depart further from cost causation and economic efficiency. Methodologies that more closely track cost causation are more complex to implement and audit. We have chosen the methodology that best balances our broad policy goals in this proceeding.

115. Adoption of a fully allocated costing methodology does not mean that we are prescribing prices for nonregulated services. It is true that the full allocation methods we have traditionally used in ratemaking allocate costs to particular services, and that these costs dictate the price of the service if cost-based rates are used. This is not a necessary attribute of fully allocated costing, however. We can avoid becoming involved in nonregulated pricing matters by treating the regulated and nonregulated sectors of company's business in the aggregate for purposes of allocating costs. The scheme we adopt below allocates common cost to the nonregulated sector but leaves it wholly to the business judgment of the company and to the market place to determine how the company recovers (or fails to recover) those costs. An additional reason for treating unregulated activities only in the aggregate is that firms may build flexible plant capacity that is intended for unregulated use in advance of specific service plans. Facilities upgrades and accelerated replacement of older facilities might also be undertaken

primarily for the benefit of unregulated service offerings. The principles adopted in this Order dictate that such costs be excluded from the regulated accounts. A requirement that costs be assigned to a specific service, on whatever basis, would therefore contradict this principle.

116. We have considered the argument that fully allocated costing may inhibit companies from offering services which can be sold at a price above incremental cost but not at a price that would cover full costs. Part of our response to this argument lies in our decision to implement full cost allocation in the aggregate, consistent with our decision that a company is free to offer each nonregulated services at whatever lawful price will maximize the company's profit from that service. We disagree, however, with the assumption that a full allocation system will inevitably assign to a telephone company's nonregulated business more overhead costs than would be reflected in the prices of competitor's products. To the extent this view is colored by problems the carriers perceive with the gross allocators and broad averages used int he current Separations Manual, our response is that carriers will have every opportunity to maximize direct assignment of costs and thereby minimize the residue of true overhead to be spread on a non-cost-causative basis. [FN220] If, on the other hand, a carrier has more overhead costs than could be tolerated by competitive companies, the public interest would best be served, not by designing a cost allocation scheme that explicitly allows carriers to draw higher levels of overhead contribution from regulated service ratepayers than they can obtain from the customers of nonregulated services, but by adopting a rule which encourages the companies to reduce all overheads to a

competitive level. [FN221] Thus we agree with DEC and other parties who argue that full allocation may encourage cost reductions that benefit the regulated customer.

117. Reliance on the MTS Guidelines Order as support for using incremental costing for nonregulated activities is misplaced. In that situation the issue was whether AT & T would be allowed to price some regulated services between incremental and fully allocated cost. We concluded that a tariff investigation normally will not be warranted if a carrier can demonstrate that net regulated revenues will be increased by an optional calling plan. When we are acting wholly within the sphere of regulation, it is possible for net revenue increases due to increased demand for the incrementally costed (lower priced) service to benefit the ratepayers generally because, due to the rate of return constraint, net increases in revenues must lead to lower rates for other services. By contrast, ratepayers do not benefit from additional revenues which might be produced by offering a nonregulated service at a lower price, since the nonregulated sector is not bound to an authorized rate of return and any revenues in excess of those needed to cover the costs of that service can be expected to be distributed to shareholders, reinvested in the nonregulated business, or used to offset the overheads which are not covered by other nonregulated services. Furthermore, in the regulated sphere we have a responsibility to enforce a statutory prohibition against unjust and unreasonable charges that encompasses rates that are unreasonably low or "predatory" as well as rates that are unreasonably high, whereas we usually have no proper interest in the prices charged for nonregulated services. [FN222]

B. Choice of Full Allocation Methods

1. Introduction

118. Our decision to use fully allocated costing rather than incremental costing to apportion costs between regulated and nonregulated activity categories does not, in itself, provide adequate guidance to the carriers, since there are probably an infinite variety of full allocation methods which could be used. Indeed, this Commission has allowed carriers to use a number of different FDC variations in the past in order to apportion costs among regulated service.

119. The three sets of FDC rules now in use, the Separations Manual, the ICAM, and the access apportionment rules, generally follow a common pattern. Investment is segregated from expenses. Each is divided into a number of categories. Each category is either assigned to a cost objective (i.e., jurisdiction, service, or access element) or apportioned between or among cost objectives according to some formula or factor. Many of the allocations prescribed by these systems are based on cost-causative principles, [FN223] while others use a more general factor [FN224] that is not closely related to the investment or expense category to which that factor is applied. Each of these FDC methods have allocated a substantial portion of the telecommunications plant on the basis of actual measured relative use.

120. In the NPRM we proposed that the carriers would develop manuals for themselves, employing methodologies and standards adopted by this Commission. [FN225] We proposed for comment two alternative sets of standards. Both approaches emphasized direct assignment of costs and discouraged use of broad composite allocators except as a last resort, for those costs which could not be allocated in a cost-causative fashion.

121. Alternative 1 followed the past pattern by using measured use to allocate telecommunications plant investment. Alternative 2 was, by contrast, forward looking: telecommunications plant investment costs and related expenses were to be allocated to each non-regulated service in accordance with the projected utilization of plant by that service. We envisioned that this second alternative would require determination of the unit costs for each activity, and that these unit costs would be determined by means of service specific cost studies. Allocations would be calculated by multiplying the unit costs by the projected demand quantities for each service.

122. Both alternatives proposed that residual expenses be allocated using a general allocator derived from three factors, total expenses, wages and assets. We specifically stated that revenues should not be included as a factor in the general allocator because revenues do not reflect the amount of resources used by a company in providing a service. The general allocator would be computed by calculating the ratios of the amounts of expenses, wages and assets directly assigned and attributed to regulated and nonregulated services. These ratios would then be averaged to derive the general allocator.

123. We further proposed to use gross book value as the measure of assets, stating that this measure would eliminate any distortions caused by accelerated depreciation of nonregulated assets. We also proposed to use total payroll instead of an employee headcount as a measure of wages. We argued that such data would be easily obtained from accounting data and would not need to be adjusted for part-time employees, new hires or terminations. Finally, in order to simplify the allocation process, we proposed that the general allocator be computed using the prior month's data.

124. We also sought comment on special problems surrounding carrier investment in new joint or common plant. We described our concern that carriers could invest in common plant originally intended for significant use in nonregulated services, and then later reallocate the nonregulated portion of that investment to regulated accounts if the nonregulated service failed. This potential for making the regulated ratepayer carry the risk of loss for nonregulated services led us to the tentative conclusion that reallocation of investment costs from nonregulated to regulated accounts should be restricted. We identified three possible methods for limiting such allocations: (1) Prohibit reallocation of joint investment to regulated operations, but allow waivers in special circumstances; (2) Initiate special audits or investigations if significant amounts of investment were shifted to regulated operations; (3) Rely on state regulators to disallow any unjustified costs in rate cases. We also sought comment on how network modernization costs and facilities available for future growth should be treated under any of these proposals.

125. These proposals occupied the bulk of the pleadings filed in this proceeding. For the sake of clarity we shall organize our treatment of these matters as follows: In this section we shall summarize and discuss the comments which addressed the proposed standards and the investment risk issues. We shall discuss in a general way the conclusions we have reached on these issues. In section C, below, we explain the cost allocation standards we are adopting in greater detail. In section D we address several specific cost allocation problems which warrant particular attention.

2. Comments

126. a. Direct Assignment. Parties universally endorse the concept of maximizing direct assignment of costs. BOCs generally claim that the draft manuals submitted with their comments abide by this principle; this claim is challenged by NATA and others. [FN226] SNET states that under the manual which it currently uses for allocating costs to non-structurally separate nonregulated activities, the vast majority of nonregulated costs are directly assigned and residual costs are comparatively small. [FN227] Various parties urge us to define as directly assignable readily identifiable portions of shared facilities [FN228] and any added costs for common equipment which are caused by nonregulated needs. [FN229]

127. b. Alternative 1 vs. alternative 2. BOCs generally prefer Alternative 2, albeit with greater or lesser degrees of enthusiasm and with various modifications. The BOCs' advocacy of this alternative is in most cases linked to their support of incremental costing. CPE vendors and enhanced service providers universally disapprove of Alternative 2, as does AT & T. Independent telephone companies, other common carriers, and state commissions are split between the two approaches. Most parties seem to be motivated in their choices by their objections to the method they reject rather than by the positive virtues of their preferred approach. Indeed, as discussed further below, a number of parties rejected both methods.

128. LECs preferring the forward-looking approach characterize the Alternative 1 (actual relative use) approach as rigid, arbitrary, and insufficiently grounded in principles of cost causation. Those carriers supporting the actual relative use method stress its relative simplicity and its welcome similarity to the familiar procedures of the Separations Manual. They express concern that service-specific cost studies proposed in the NPRM could be so difficult and expensive as to be beyond the capabilities and resources of many LECs. Some oppose the forward-looking approach on the grounds that the cost studies would expose proprietary information to an unacceptable level of public scrutiny.

129. Parties other than LECs argue that the Alternative 2 method is not only difficult to implement, but also difficult to monitor; some characterize it as unauditable. Peat Marwick, in a report prepared for AT & T and submitted by AT & T as an Appendix to its Reply Comments, states that we might not be able to obtain any better than a negative assurance from an attest audit of a cost allocation plan based upon service cost studies and demand forecasts. [FN230]

130. Many parties object to use of demand projections rather than actual measured use on the grounds that such projections are both unreliable and unverifiable. They take the position that the companies will inevitably understate projected nonregulated demand to achieve the smallest possible allocation of costs to nonregulated activities. [FN231] Several carriers respond to this allegation. Bell South argues that carriers have an incentive to forecast nonregulated demand accurately, because, if they underforecast and thereby cause a shortage of capacity, regulated needs will be met first. [FN232] Pacific Telesis states that forecasts are safeguards, not opportunities for abuse, since they will be used to assure that nonregulated activities bear the cost of investments intended for their use. [FN233]

131. Some argue that Alternative 2 as described in the NPRM violates CASB standards by apparently allowing different, inconsistent methodologies to be used to cost different services. [FN234] Others believe that the Alternative 2 proposal would require unit costs to be developed only for nonregulated services; they claim this would inevitably result in treating the regulated sector as the residual repository for costs that escape direct attribution to nonregulated activity but which nevertheless are caused by, or provide benefit to, the nonregulated sector. [FN235]

132. In the eyes of some parties, our forward-looking alternative is but a thinly-disguised version of the Long Run Incremental Costing (LRIC) method we rejected for AT & T's regulated services in Docket 18128. [FN236] Others who remember Docket 18128 see, not LRIC reincarnate, but the ghost of FDC Method 7; they remind us of the failure of that approach and predict that the current proposal would suffer the same fate. [FN237]

133. California takes the position that no known methodology provides answers to what it sees as the critical question: whether or not there are any economies of scale or scope to be gained be allowing entry into nonregulated activities. It suggests we adopt some version of alternative # 2, but only for a limited period of time while we develop something better.

134. c. Allocation of investment risk. A number of carriers and their representatives contend that the question whether investment once allocated to nonregulated activity should be allowed to reenter the ratebase should be left to state regulators to decide in rate cases. [FN238] Most states, on the other hand, take the position that "stranded" nonregulated investment should never be allowed back into the rate base [FN239], or should be allowed in the rate base only under special circumstances that would justify a waiver. [FN240] Idaho observes that relying solely on state disallowances is unacceptable, not only because of limited state resources, but because rate cases may not occur during periods when carriers are earning excess profits. [FN241] Florida prefers the approach under which substantial shifts in allocation of of common investment trigger an investigation. Florida also notes that requiring a waiver for any shift would be logically inconsistent with the Alternative 1 proposal to allocate common plant on the basis of current relative use, since current relative use allocations always shift in response to the relative demand for services. [FN242]

135. AT & T argues that a relative use allocation scheme could be developed that answers all legitimate concerns about shifting investment allocations. Under AT & T's approach, actual use would be studied periodically. In between study periods, allocation percentages would not be permitted to shift with variations in actual measured use. When new periodic studies were done, this Commission would exercise "strict control" over any shifting from nonregulated to regulated. AT & T suggests that a threshold limit, for example 2 percent, be established, and that shifts of a magnitude above that threshold be prohibited unless the carrier can show that the plant is needed for regulated activities. [FN243] In response to parties such as ADAPSO, Arthur Andersen, and California, who argue that relative use allocations assign cost to new ventures only as they become successful, thereby sparing those activities from risk, AT & T suggests that projected use could be used for new offerings until relatively stable usage data becomes available. [FN244]

136. Several parties take the position that neither of our cost allocation alternatives protects adequately against shifting of investment risk; they present alternative approaches which

they believe to be superior. The Department of Justice argues that common equipment should not be apportioned on the basis of either actual or projected usage. Rather, they say, nonregulated activities should be assigned all of the long run incremental costs that are caused by those activities. They give the following example to explain their approach: If there is a commonly used switch that costs $10, but a switch that could perform only the regulated service would cost $8, then $2 must be allocated to nonregulated activities regardless of actual or projected usage. [FN245] Indeed, according to DOJ, investment in dual function equipment should be apportioned between regulated and nonregulated activities even if no nonregulated service is ever offered. DOJ's approach also requires that, if nonregulated activities use embedded facilities that could have been leased or sold to third parties, then the opportunity cost should be directly attributed to nonregulated activities. [FN246] DOJ notes that allocation of investment based on causation requires inquiry into the actual reasons for investment decisions, and that such causation data may be difficult to capture. [FN247] DOJ argues that the company should always be barred from reabsorbing useless nonregulated investment into the rate base, and that if the regulated business requires the use of such assets they should be transferred in accordance with the transfer pricing rules that apply to affiliate transactions.

137. IBM advocates a cost-causational approach in which a carrier would make a permanent allocation of each shared depreciable asset based on its intended use at the time of acquisition or, in the case of an embedded asset, at the time the asset is first shared. Under IBM's proposal, this allocation would be reflected by recording the nonregulated portion of any shared asset in a separate subsidiary record associated with the regulated asset account in which the cost of the asset is recorded. [FN248] IBM states that, under such a system, both the FCC and the independent auditor would need to have access to supporting documents for all carrier investment decisions. [FN249]

138. SWB opposes the DOJ and IBM proposals as inappropriate in three respects. First, according to SWB, allocation of investment based on intended use does not solve the problem of risk allocation. A carrier could have the intention of first using an asset for nonregulated activities for a short while, and then using it to supply capacity needed for growth on the regulated side after the cancellation of the nonregulated activity. How, asks SWB, could such an intention be questioned? Second, argues SWB, nonregulated firms do not usually base acquisition of long-lived assets upon projections of usage for particular products over the entire life of the asset. SWB cites the example of an automobile manufacturer that builds a factory with a forty-year life. SWB states that such a manufacturer will not predict what models of car it will build in that factory over the entire life of the investment. It will develop multi-year plans, but it will allocate costs on an annual basis. Third, SWB expresses the view that state regulators will find statements or projections about long-term use of an asset to be speculative and inherently unreliable. [FN250]

139. Several other alternative approaches are suggested by various parties. These include

requiring all asset allocations to take the form of affiliate transactions and to be priced in accordance with our affiliate transaction proposal; [FN251] negotiating asset allocations in three-way meetings among carrier, state regulators, and this Commission; [FN252] and requiring the nonregulated activity to enter into a contract for use of regulated facilities that included a maximum termination liability clause similar to provisions used in tariffs when a carrier constructs facilities to serve a specific customer's needs. [FN253]

140. d. General allocator. Four commentors supported the NPRM's proposal, generally with little comment. [FN254] The remaining parties recommended specific modifications to the proposed general allocator, or offered their own proposals. Several parties argued that we should use more than one allocator, tailoring the allocator to the characteristics of specific activities or costs. [FN255] Two parties argued that, whichever formula is chosen for the general allocator, the total amount of residual costs identified by telephone companies should be limited. [FN256]

141. Many of the commenting parties did not object to the proposed general allocator per se, but did contest one or more of the constituent factors listed in the NPRM. Several parties argue that the general allocator should not include both wages and total expenses. [FN257] These commentors argue that, because wage expense is incorporated into total expenses, including both of these factors in the general allocator would effectively double-count wages. These parties generally argue that we should simply delete wages as a factor in computing the general allocator and use total expenses alone. Conversely, NYNEX argues that the use of total expenses may distort the general allocator if a carrier uses a purchasing affiliate with a high cost of goods sold. [FN258]

142. Commentors differ on the issue of including both directly assigned and attributed costs in the general allocator. MCI and Florida support the NPRM's proposal to use both types of costs in the computation. [FN259] ANPA, IDCMA and Xerox propose that only directly allocated costs be included. [FN260] These parties generally argue that limiting the computation to directly-assigned costs will provide an incentive for carriers to maximize the amount of costs they directly assign.

143. Six parties oppose the NPRM's proposal to use gross book amounts in calculating the general allocator. [FN261] The reasons for preferring net book costs are varied. These parties generally argue that use of gross book is inconsistent with our decision to include total expenses. They contend that gross book includes undepreciated plant costs, while total company expenses include depreciation expense. The parties therefore conclude that use of both gross book and total expense will double-count depreciation costs. United argues that the Cost Accounting Standards Board advocated use of net book. PacTel also argues that gross book underallocates to nonregulated activities in the early years of a service.

144. In addition, the comments evince a wide range of opinion regarding the derivation

of the data to be used in computing the general allocator. The record includes some support for the NPRM's proposal that prior-month's data be used. [FN262] Several parties assert that data should be averaged over a quarterly, semi-annual or annual period to smooth out aberrant monthly fluctuations. [FN263] Florida argues that, because it supports allocations after the carriers' books are closed, current data should be used. [FN264] California also supports the use of current data, except in the case of new services, where it contends that three- to five-year forecasted data should be used. [FN265] A final modification of the NPRM's proposed general allocator is suggested by Centel, which argues that revenues should be included in the general allocator computation. [FN266] Centel avers that the NPRM's proposal, which includes investment, would underallocate costs to mature, newly- deregulated activities, which have few assets but significant revenues. Centel therefore proposes a general allocator that would include a measure of revenues.

145. In addition to the comments described above, several parties proposed alternative general allocators, wholly separate from that described in the NPRM. BellSouth proposes an elaborate accounting scheme that would tailor different allocators to specific service categories. [FN267] Ameritech and GTOCs propose allocation schemes premised on incremental costing that would not employ a general allocator, but would provide some contribution to common overheads from nonregulated activities, [FN268] or would allocate residual costs according to market constraints or on a contribution principle. [FN269] SWB would allocate residual costs on a per-product or per-service basis. It would not employ a three-factor allocator, but would allocate such costs on the basis of all previously assigned direct, common and general overhead costs in a given product or service category. [FN270]

146. SNET proposes a general allocator based on payroll, operating revenues, net assets and inventory. [FN271] It maintains that it has used this allocator in the past, and that it is accurate. It also argues that no particular allocator formula should be prescribed by this Commission. Sprint would allocate residual costs on the basis of common plant costs or employee wages, whichever is greater. [FN272] California would compute a general allocator using operating revenues, operating expenses and employee wages. [FN273] Finally, Arkansas argues that a general allocator should be applied after separations, because use of the allocator prior to separations would cause improper cost shifting. [FN274]

3. Discussion

147. a. Alternative 1 vs. alternative 2; allocation of investment risk. Careful consideration of the comments of interested parties leads us to the conclusion that neither of our cost allocation proposals can be adopted verbatim. The cost pool structure of Alternative 1, which treats nonregulated activities in the aggregate, offers many advantages in terms of ease of monitoring, auditability, and appropriate treatment of proprietary information. [FN275] We are convinced, however, that the Alternative 1 method of apportioning plant costs based on current

relative use, would not adequately assure that nonregulated activities bear their full share of the risk of investment in telecommunications plant. The forward-looking Approach of Alternative 2, on the other hand, offers more possibilities for handling the investment risk problem; yet we agree with the parties who believe that a cost allocation manual based on service-specific cost studies could be difficult to administer for the carriers.

148. In view of these concerns, we are adopting cost allocation standards which incorporate the desirable elements of each alternative, with emphasis on direct assignment and cost causation. These standards embody an attributable cost method of allocating costs between regulated and nonregulated services. Under this methodology, all costs with either a direct or an indirect causal link to either regulated or nonregulated activities will be directly assigned to the appropriate activity. The remaining costs will then be apportioned between the regulated and nonregulated

activities. Cost causational attribution factors will be used whenever possible, and the remaining costs will be apportioned on the basis of a general allocator.

149. The methodology that we are adopting draws from both Alternative 1 and Alternative 2 of the NPRM, and also from the comments of many of the parties. As discussed, supra, many objections were raised to both alternatives of the NPRM. In response to those objections and to the many alternative suggestions provided by the parties, we have developed the attributable cost methodology that we are adopting here. The attributable cost methodology uses the FDC principles that were central to Alternative 1 and thus is responsive to the concern expressed by some parties that the nonregulated services would be charged only incremental cost. The attributable cost methodology also uses the forward looking cost-causation principles that were central to Alternative 2 for some investment and related expenses and consequently is responsive to the concern expressed by some parties that the allocations would be arbitrary and unrelated to cost causation.

150. Although the attributable cost methodology that we are adopting uses elements from both alternatives of the NPRM and from proposals of the parties, it is not merely a compromise among the various plans. The attributable cost methodology in general is a well defined and commonly used method of distributing costs among activities. The attributable cost methodology that we are adopting is similar to the proposal of the Department of Justice in this proceeding. According to the Department of Justice, the attributable cost method is subsidy-free and satisfies various technical criteria that are desirable characteristics of cost allocations. [FN276]

151. The attributable cost method described by the Department of Justice requires the computation of the incremental cost of each service. The cost allocation to each service is the incremental cost of the service plus a share of common costs computed in proportion to the incremental costs. Our methodology is similar in general concept, but is adapted to satisfy our

concerns regarding implementation and auditability. As previously noted, we have decided that the procedures adopted in this Report and Order will not be used to apportion costs among particular regulated or nonregulated products or services. We are adopting a two category (i.e., regulated and nonregulated) apportionment that will be supplemented with other apportionments among regulated activities such as those described in the Separations Manual. Our approach also differs in other respects. Rather than beginning with a computation of incremental cost, we begin with a computation of all direct and indirect costs that can be attributed on a cost causational basis. Our cost causation principles are similar to long run incremental costs but also contain some allocated costs that would not be considered incremental costs under the Department of Justice proposal. Our approach to implementing the attributable cost method of cost allocation leads us to the following principles that should be followed in each cost manual submitted for our approval.

152. In our NPRM we proposed a hierarchy of principles which should be used in the allocation of costs: that dedicated costs should be directly assigned; that common costs should be allocated based upon a direct measure of relative use if possible, otherwise on an indirect measure of use; and that if no adequate direct or indirect measure could be devised, then a general allocator should be used. After considering the comments of the parties we now conclude that the general principles espoused in the NPRM are reasonable.

153. We intend to make two additions to our apportionment principles. As we discuss below, we will require that investment allocators be based on forward- looking instead of actual relative use measures in order to more adequately reflect cost-causation principles and thus properly allocate investment risk. Additionally, we are incorporating in our principles the accounting to be accorded the revenues associated with any service that the nonregulated activity obtains from the regulated side at tariffed rates. The purpose of this accounting is to ensure recognition, in the regulated revenue requirement, of the revenue associated with the regulated service provided to the nonregulated activity.

154. b. Other proposals While we disagree with the carriers who argue that state regulation of the rate base is sufficient to assure that the rate base is not burdened with investment intended for nonregulated use, we acknowledge that state regulators have a unique vantage point for observing investment patterns of LECs. Rate case proceedings may bring to light problems that warrant our attention. We shall, therefore, require each carrier filing a cost manual to notify us of significant state disallowances of investments or expenses that are shared with nonregulated activities.

155. We reject the suggestion of some parties that all asset allocations be treated as arms-length affiliate transactions. This suggestion runs counter to our determinations in Computer III and the Structural Relief Proceedings. Negotiation of asset allocations in three-way meetings, as suggested by Missouri, is administratively impracticable. The suggestion of the

television networks that the nonregulated activity enter into a contract for facilities that includes a termination liability clause would have considerable merit if the carrier also entered into such contracts with third parties. In the absence of third party transactions with which we could compare the terms of the non-arms-length agreements between carriers and their nonregulated activities however, we could not assume that such agreements were reasonable.

156. c. General allocator We have decided to depart from the general allocator proposed in the NPRM, and to adopt a single-factor allocator based on total company expense. 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. [FN277]

157. We will not accept the arguments that we adopt several allocators. Most of the parties supporting multiple allocators also proposed accounting schemes that involved service categories or per-product cost categories. Because we are not adopting these accounting schemes, multiple allocators premised on such classification systems would be inappropriate. In addition, we find that multiple allocators would be unnecessarily complicated, and no carrier has shown that such allocators would yield a greater level of accuracy or reliability than the general allocator that we are adopting in this Order.

158. We find that commentors' arguments that we should compute the general allocator based solely on directly assigned costs alone are not persuasive. These arguments are primarily supported by the contention that such a requirement would provide an incentive for carriers to maximize their directly assigned costs. We find that, while such a goal is desirable, we do not disapprove of carriers attributing costs to regulated and nonregulated activities on the basis of objective, verifiable measurements, and find that such attributions are often necessary. As stated above, our cost allocation standards require carriers to maximize the amounts of costs that are directly assigned and attributed, and we believe that this requirement will suffice to provide accurate data. We therefore accept the arguments of the parties that support the NPRM's proposal that both directly assigned and attributable costs be used in computing the general allocator.

159. We need not address the arguments that gross book amounts, rather than net investment, be used in computing the general allocator. As we describe below, we will eliminate assets as a factor in the computation. This action effectively moots the gross/net book arguments. Regarding the derivation of the data to be used, we will adopt the Florida and California recommendations that we use current data in computing the general allocator. We find that it will not be necessary to average out our data over extended periods. The parties supporting this approach have not shown that any monthly fluctuations in costs that do occur will indicate aberrant cost behavior or that any purported fluctuations will otherwise affect the accuracy of the

general allocator. In addition, we will not accept the California recommendation that new services derive cost data from three- to five-year projections. We find that such projections may overstate the amount of overhead costs fairly allocable to a service. We will, however, require that such services use one-year projections in estimating their monthly costs.

160. We will not accept the Centel argument that revenues be included as a factor in computing the general allocator. Centel has not provided any argument to controvert the NPRM's argument that "revenues measure only the ability of an activity to bear costs, and not the amount of resources used by the activity." [FN278] We do find merit, however, in Centel's argument that an allocator that includes investment may not be appropriate for services that use relatively few assets. We find that the general allocator that we are adopting in this Order, by using only total expenses and deleting assets as a factor, adequately responds to Centel's concerns.

C. Cost Allocation Standards and Guidelines

1. Basic standards

161. With the above modifications, we are adopting the following general principles:

(a) Carriers required to separate their regulated costs from nonregulated costs shall use the attributable cost method of cost allocation for such purpose.

(b) In assigning or allocating costs to regulated and nonregulated activities, carriers shall follow the principles described herein.

(1) Tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service.

(2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

(3) Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:

(i) Whenever possible, common cost categories are to be allocated based upon direct

analysis of the origin of the costs themselves. [FN279]

(ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available. [FN280]

(iii) When neither direct nor indirect measures of cost causation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

(4) The allocation of central office equipment and outside plant investment cost between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment at the highest forecast relative nonregulated usage over the life of the investment.

2. Maximization of attribution

162. We stressed in our NPRM that the most important review criterion for a manual is the extent to which it minimizes the use of general allocators to distribute costs. We continue to believe that the effectiveness of any manual depends upon the degree to which the carrier using it can assign costs to the activity (regulated or nonregulated) that caused those costs. We believe that a carrier can assign, through the use of a well designed cost allocation manual, a very high percentage of its costs on a cost causative basis, either directly, through analysis of the origin of the costs themselves, or indirectly, through some logical linkage of cost causation to a directly assigned cost. While we will not, at this time, specify individual goals for percentage of costs directly and indirectly assigned, we emphasize that direct assignment is the primary method to be used, and that indirect assignment is a secondary method, only to be used when the strongest link of cost causation is through another directly assigned cost.

163. Although the above discussion has been couched in terms of Part 32 accounts, we do not believe that our cost allocation methods can be implemented at that high a level of aggregation. Some of those accounts contain costs for more than one function. More importantly, we believe that most accounts will require the use of more than one of our allocation principles to achieve a complete apportionment of their costs. The use of function codes, subaccounts and other subsidiary records is essential to the maximization of direct and indirect allocation. We recognize that the larger part of, e.g., maintenance expense, [FN281] might be allocated indirectly, on the basis of the plant investment on which the maintenance was done. There is no reason, however, that the maintenance expense on plant used for regulated and nonregulated purposes will be identical, and we believe that some key maintenance expenses can be directly assigned through the use of function codes and subaccounts. We are convinced that, since there are a limited number of expense accounts in Part 32, subaccounts and function codes

must be used to maximize direct and indirect assignments. In general in our reviews and audits we will seek to identify costs that can in fact be directly or indirectly assigned.

3. Cost categories

164. In our NPRM we stated that costs must be grouped at the subaccount and subsidiary record level into categories (i.e. in the language of the NPRM: logical, homogeneous, statewide pools) that maximize the extent to which cost causative allocation factors can be used to divide the costs between regulated and nonregulated activities. [FN282] The scope and nature of nonregulated activities that the carriers may ultimately undertake will determine the number of cost categories that an acceptable manual would require. We believe that the number of categories used in the manuals is critical to its potential for success. A very coarse categorization of costs, which would be acceptable for a carrier providing only a very limited amount of nonregulated service, would be unacceptably imprecise for allocating costs for a carrier extensively engaged in nonregulated activities.

165. We recognize, however, that even for a carrier extensively involved in nonregulated activities, a manual with thousands of categories could become costly to implement and impractical to monitor. We expect that the number of categories will be limited by the diminishing marginal improvement in allocation precision to be gained by another cost category compared to the added implementation and administration expense. Stability is another consideration. The larger the number of categories, the more narrowly defined those categories become. Beyond some level of categorization, every change in nonregulated operations would require recasting the category boundaries and redefining the allocation factors. The stability of the cost categories is an important determinant of the cost of applying and administering the manuals, and of the accuracy of the allocation.

166. An example of how the categorization might be implemented is as follows. A carrier has in operation 30 switches. Let us say that ten of these switches are going to be the major source of nonregulated activities, with another twenty switches being involved to a much lesser extent. The twenty switches could be allocated together. The first ten would also be grouped, but before allocation their costs would be categorized in more detail to allow more precise allocators to be developed. If the regulated and the nonregulated activities made use of the switches in quite different ways, then their costs might be segregated into a number of categories to capture the difference in usage. For example, certain memory devices in the switches might be separated from the network portion of the switches if the regulated and nonregulated operations made use of these devices in a different proportion than they made use of the network portion.

4. Forward-looking investment allocators

167. The accurate allocation of costs on a cost causational basis depends upon the correct identification of the activity that is supported by the cost. Costs are incurred in anticipation of future demand and, depending upon the cost category, allocators based on even the most recently available pattern of relative use may result in large retrospective accounting adjustments when the costs are trued up to actual costs because of shifts in relative demand. The problem is most pronounced for investment costs since only a small portion of the investment will be recovered by the revenue from current use. To take an extreme example, the cable vaults under city streets are built for the highest demand imaginable over their operating lives because their capacity is quite literally set in concrete. Central office switching equipment can be expanded in capacity on shorter notice, but the decision to incur the cost of equipping a switch with an additional circuit is not based simply on the immediate demand for service. [FN283] It is based on a forecast that the circuit's costs can be recovered over its expected service life.

168. For network plant investment (i.e., central office equipment and outside plant) capacity is based upon the anticipated, not the current demand level. We believe the lag between investment and demand can be taken into account by basing the allocation factor on forecasted and not actual relative regulated and nonregulated use. The forecast will cover the planning period that the carrier established for each investment category. A specific showing will have to be made to establish a forecast period that is shorter than the average depreciation life of the plant in each category of investment.

169. We have identified two additional concerns relating to the allocation of investment that require further consideration. Our first concern is that the costs associated with an investment be allocated between regulated and nonregulated operations on the basis of the intended relative use and not on the actual relative use over the investment's life. If a cost were incurred largely to provide for future nonregulated services, and these services failed to grow as expected, we would not want the nonregulated share of the cost to fall on regulated operations and, therefore, be charged to ratepayers. In order to insulate the ratepayer from the risk of nonregulated business failures, we propose to restrict our general allocation rule so that for a given account within a given investment category, absent waiver, [FN284] the nonregulated investment can not decrease from one year to the next. An exception to this rule would be for a category in which the total demand has begun to decline and is expected to continue to decline until it is exhausted. In this case the attribution factor will be frozen at the level that applied during the period in which the total demand peaked.

170. Our second concern relating to the allocation of investment is that if the forecast of relative use under-estimates nonregulated use, then the regulated operation will bear costs that are actually being incurred for the benefit of the nonregulated operation. We recognize that, given the long planning horizon of some investments, inevitably some under-forecasting of nonregulated demand will occur. To protect ratepayers from such burdens we will closely monitor actual and forecasted usage. If reallocations of telecommunications plant (i.e., central

office equipment and outside plant) from regulated to nonregulated operations are required, such plant will be transferred at undepreciated baseline cost plus an interest charge to reflect the time value of money. The authorized interstate return that is in effect for each relevant period will be used to compute the charge. The baseline cost will either be the depreciated original cost at

the time of the initial assignment or allocation of existing plant or the original cost of subsequently acquired new plant.

171. The imposition of an interest charge serves two purposes. The first is to compensate the regulated operation for the time value of the costs it bore for the nonregulated operation. The second purpose is to overcome the incentive for the carrier to underestimate its future nonregulated demand to avoid committing plant capacity to the nonregulated operation. The incentive to underforecast nonregulated demand is a strong one because the plant allocated to nonregulated operations is permanently removed from the revenue requirement of the regulated activity. Our first purpose could be satisfied by simply applying the currently prescribed weighted average cost of capital to the reallocated costs. Our second requires that the rate be sufficiently high to deter under-forecasting.

172. A reallocation of telecommunications plant from nonregulated to regulated activities will require advance approval by this Commission. If such reallocations occur, the reallocations will be made at the depreciated baseline cost.

5. Expenses

173. Many plant related expenses will incorporate our concept of a forward- looking allocation because they will be indirectly allocated on the basis of plant investment, which is allocated on the basis of forecasted peak demand. The exception will be maintenance expense, which will not be allocated on peak relative use because we believe that maintenance expense more closely tracks the current usage of plant than the long term forecasted usage. For non-plant related operating expenses that are to be allocated directly, through the use of time reporting or of some other relative use estimator, we believe that, while there is an element of anticipation in the decision to incur most of these costs, the gain from attempting to capture it via a forward-looking allocator is small relative to its implementation and administrative expense. We note that embodied in the definition of operating expense is the accounting principle that such costs are of short term consequence. Accordingly we adopt our NPRM proposal that these cost categories should be allocated on the basis of current relative regulated/nonregulated use. We will monitor the results of expense allocations and compare those results with the forecasts of nonregulated expense levels that the carriers use in developing the regulated expense projections upon which their tariff filings are based.

D. Special Cost Allocation Problems

1. Time reporting

174. a. Introduction. In the NPRM, we reviewed two methods of time reporting used by carriers to allocate labor costs, positive time reporting (PTR) [FN285] and exception time reporting (ETR). [FN286] We tentatively concluded that we would not prescribe changes in the carriers' current reporting systems because there was no clear advantage in prescribing one method or the other and because either method of time reporting provides more accurate attributions of labor costs than derived allocation factors. [FN287] At the same time, we noted that time reporting systems could be manipulated or flawed by reporting errors, and we solicited comments on guidelines, safeguards or procedures that would enhance the accuracy of time reporting. We also requested that companies describe their time reporting systems to us. In response, we received from numerous parties comments that covered a wide range of options.

175. The LECs report a variety of time reporting systems currently in use, although some common characteristics are apparent among the carriers. Most LECs use both positive and exception time reporting, as deemed appropriate for different jobs and functions. [FN288] Exception time reporting is frequently used for workers who work in a small number of well-defined activities, such as legal or accounting department staff. Positive time reporting is generally used by personnel who perform a variety of functions as the need arises, such as plant maintenance personnel. Most do not require upper-level managers to report their time. Time is reported in increments ranging from fifteen minutes to four hours. The carriers that addressed the issue are also divided on the practice of using reported time as a basis for worker compensation. Several carriers use time reports to prepare their payroll, while others use time reporting primarily for budgeting and monitoring purposes.

176. For reasons discussed below, we conclude that carriers should retain the flexibility to use either ETR or PTR. We will, however, require that documentation maintained by managers that may aid our auditing efforts be retained by the carriers for a period of one year. We also require carriers to implement and describe in their manuals reporting methods or studies designed to measure and allocate non-productive time.

177. b. Comments. The LECs filing comments on this issue generally argue that the time reporting systems currently in use should be retained. They argue that, because time reporting is used as a basis for budgeting and payroll, clear reporting guidelines, incentive programs and strict internal controls have been established to ensure reliability and accuracy. [FN289] The possibility of Commission audits is also cited as a factor that promotes accurate reporting. [FN290]

178. Many of the other commenters argue that time reporting is inherently unreliable and seek restrictions on carriers' discretion in conducting time reporting. Most of these commenters argue that exception time reporting should not be allowed, and that positive time reporting should

be required. [FN291] Parties allege that ETR is flawed by employees' recollection and reporting errors, and argue that any time an employee forgets or fails to report his time, the ETR system automatically assumes that unreported time should be allocated to the designated activity. These parties conclude that, because the majority of carriers' operations involve regulated services, a majority of personnel would be designated to regulated activities, and the majority of unreported time would be assigned to regulated operations. In addition, it is argued that PTR facilitates direct assignment of labor costs. Finally, several parties argue that the assumption underlying ETR--that all nonreported time should be attributed to a predesignated activity--is inherently flawed. They argue that the majority of labor hours are dedicated to regulated activities, and that regulated accounts invariably will be the default repository of unreported time under an ETR system. They argue that, because employees seldom report nonproductive time, and may forget to report time spent on unregulated activities, all such time will be allocated to the regulated accounts. In addition, exception time spent on non-designated projects is only recorded if it exceeds a particular increment. For instance, if the ETR reporting increment chosen by the carrier is one hour, but an employee only works on a non-designated task for 45 minutes, that time is not reported, but is allocated by default to the designated account. It is argued that these costs will also be allocated predominantly to the regulated accounts.

179. Conversely, IBM argues that exception time reporting should be required. [FN292] IBM states that positive time reporting is inherently subjective and unreliable, and that the natural inclination of managers to reduce the costs of nonregulated activities instills a systemic bias that will shift costs to regulated accounts. To correct these asserted biases in PTR, IBM suggests that carriers should designate personnel 100 percent to regulated or nonregulated service, depending on their primary function. ETR may then be used as necessary to account for work done by personnel in nondesignated activities.

180. AT & T responds to the IBM argument, stating that, if the IBM proposal is intended to force carriers to dedicate their personnel entirely to regulated or nonregulated activities, it should be rejected as perpetuating a form of structural separation. AT & T further argues that, if the IBM proposal would allow pre-assigned personnel to be reassigned to other activities as necessary, then the IBM proposal is not dissimilar to positive time reporting. [FN293]

181. In addition to the debate over the appropriate time reporting methodology, several carriers also address more specific concerns. [FN294] Parties argue that carriers should be required to keep manager logs and other supplementary documentation to aid in auditing. They argue that these documents and all relevant memos and other correspondence should be kept by the carriers for up to four years. [FN295] Parties also argue that time reports should reflect contemporaneous, daily reporting, not weekly summaries, that time should be reported in fifteen-minute increments, and that all timesheet entries should be made in ink, with any changes noted and explained. [FN296] Finally, several state commissions argue that no time reporting system can be made foolproof, and that we should rely on auditing to uncover misreporting and

misallocation of labor hours. [FN297]

182. c. Discussion. We find that both ETR and PTR methods possess unique advantages and disadvantages and that an indiscriminate prescription of either method for application to all labor functions in all carriers is neither feasible nor desirable. We reject the argument that PTR should be prescribed because it facilitates direct assignment. The record fails to show that PTR is more effective than ETR in this regard. Similarly, we reject the argument that designation of all employees wholly to regulated or unregulated service is necessary to eliminate bias in the reporting system. We also note that for some job functions, such as maintenance of equipment used in common by regulated and nonregulated activities, it may be impossible to designate an employees' time as 100 percent regulated or nonregulated. Also, in an environment which may witness dramatic growth in unregulated activities over current levels, 100 percent designation of labor resources may not be practicable.

183. At the same time, we appreciate the concerns of the parties that argue that time reporting systems are inherently inexact and subjective, and that they may provide a mechanism by which labor costs are inadvertently or intentionally misallocated. In addressing these concerns, we agree with the state commissions that argue that the auditing function is the appropriate vehicle for evaluating the accuracy of individual carriers' time reporting systems. Although we will not prescribe a particular time reporting system for any carrier, we will adopt some guidelines and requirements designed to provide a complete and accessible paper trail.

184. We share the concern raised by many parties: that time not reported and nonproductive time could fall disproportionately to regulated activities. While we generally reject the LEC arguments that internal controls and accounting procedures suffice to insure against such misallocations, we recognize that internal controls are essential in minimizing unreported time. We therefore require that all carriers include in their cost manuals a description of the methods used to teach, monitor and reinforce accurate time reporting by employees.

185. We also find that additional steps are required. We require that time be reported in increments of one hour or less for both ETR and PTR systems. We specifically require that NYNEX discontinue the use of four-hour increments in ETR. This is the same reporting requirement we imposed upon AT & T in a 1982 Order. We found that four-hour increments were unacceptably inexact and could result in the misallocation of substantial amounts of labor time. [FN298] We will, at least at this time, reject the arguments of the Florida PSC and IDCMA that 15-minute increments be prescribed. The record does not indicate that one-hour increments would be inappropriate. [FN299] We note, however, that several carriers use fifteen-minute increments, and that our auditors will experience a broad sampling of time reporting methods. If the audits disclose that one-hour increments are not sufficiently precise, we may require a smaller increment in the future.

186. We accept in part IDCMA's argument that the reporting and documentation standards adopted in Docket 85-26 [FN300] should be applied to all carrier time reporting in the instant proceeding. In that Docket, we found that weekly time summaries of marketing personnel hours kept by AT & T were not sufficient for auditing purposes. We therefore required that AT & T maintain for Commission inspection all relevant records, including telephone and appointment logs, notes kept by employees and managers, memos and other correspondence. We note that Docket 85-26 addressed marketing and sales personnel, who routinely keep well-documented records of their activities. As discussed infra in this Order, we require that marketing and sales personnel required to keep such records in Docket 85-26 be held to the same reporting standards in the current proceeding. To the extent that supervisors of other personnel maintain assignment logs or similar records, we find that such materials would be useful to Commission, state and independent auditors in conducting audits pursuant to the instant proceeding. We reject arguments that such records should be kept for three or four years, and find that a one-year period will be sufficient to allow access to all relevant data without unduly burdening the carriers. We reject IDCMA's arguments that additional reports be maintained and that all time report entries be made in ink, and find such requirements unnecessary absent a showing to the contrary.

187. We are also concerned with the allocation of non-productive time. Such time includes necessary functions such as vacation, sick leave, breaks, administrative activities and conferences, informal instruction to fellow employees working on other projects, and countless other activities that are not directly related to the employee's designated project. We do not believe that any particular method is preferred for allocating non-productive time, [FN301] but we are concerned that such time be captured and allocated to the appropriate accounts. We therefore require that carriers include in their manuals a description of the reporting methods or studies used to capture non- productive time, and, if not all non-productive time is captured through positive time reporting, the methods by which such time is allocated. We realize that, under any apportionment method, some judgment must be exercised in identifying and allocating non-productive time. [FN302] Documentation supporting such decisions should be kept in accordance with the discussion in the preceding paragraph.

2. Marketing costs

188. a. Introduction. In the NPRM, we noted that the apportionment of expenses associated with combined marketing of regulated and nonregulated services and products is a difficult issue that merits special attention. We reviewed other Commission proceedings in which parties filing comments argued that marketing costs are impossible to allocate between regulated and nonregulated activities. These parties generally concluded that we should either prohibit all combined marketing or allocate all such costs to nonregulated activities. In the NPRM, we questioned the presumption that joint marketing costs are impossible to allocate. We did recognize that, in cases involving the sale of integrated telecommunications systems that consist of basic and enhanced services and CPE, precise allocation of some of the marketing costs

between regulated and nonregulated services may not be possible. We stated our belief, however, that these unidentifiable costs are small in comparison to the total of all marketing costs. We cited product- specific advertising, sales commissions, engineering and design support, bid preparation and product-related training as examples of costs that are largely amenable to direct assignment or allocation based on objectively verifiable direct or surrogate measures of use.

189. We then defined marketing costs as those costs recorded in Accounts 640- 650, with the exception of those recorded in Account 644. We tentatively concluded that all costs that can be allocated based on direct assignment or cost causational measures should be so allocated, and that all unallocable costs should be divided between regulated and nonregulated activities based on the ratio of the allocated costs. We specifically sought comment on the merits of using directly assigned costs alone or the proposed general allocator as a basis for allocations.

190. For reasons discussed below, we will adopt the apportionment scheme proposed in the NPRM. 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. In addition, we will require that the reporting and documentation standards applied to AT & T marketing personnel in Docket 85-26 be applied to the LECs as well.

191. b. Comments. The comments evince considerable support for the NPRM's proposal, although several parties recommend alternative methods for allocating joint marketing costs. Four parties approve the tentative conclusion stated in the NPRM without modification. [FN303] In addition, BellSouth and AT & T support that approach, but recommend modifications. BellSouth agrees with our tentative conclusion that Account 644 should be excluded from any calculation of allocation ratios, but also argues that Accounts 648 (Public Telephone Commissions) and 649 (Directory Expenses), and certain elements [FN304] of Accounts 640 (General Commercial Administration), 642 (Advertising), 643 (Sales Expense) and 645 (Local Commercial Operations) should also be excluded. [FN305] BellSouth argues that these accounts do not bear any causal or beneficial relationship to the proposed service categories. [FN306] AT & T generally endorses our proposed treatment of joint marketing costs, but stipulates that residual marketing costs should be allocated using directly assigned wages, and residual Account 650 costs (Other Commercial Expenses) should follow the allocation of the marketing costs included in Accounts 640, 642, 643, 644, 645, 648 and 649. [FN307]

192. In response to our request for alternative measures for allocating residual marketing costs, six parties argue that we should use directly- assigned costs, rather than aggregating directly-assigned and attributable costs, as the basis for residual allocations. [FN308] US Sprint opposes this option, arguing that limiting the allocator to directly-assigned costs could provide an incentive for carriers to directly assign only selected costs in order to manipulate their

allocators. [FN309]

193. Rochester argues that the general allocator should be applied to residual marketing costs, contending that the use of an aggregate factor will reduce the likelihood that temporary anomalies will cause misallocations. [FN310] This proposal is opposed by AT & T and DCPUC, which argue that the General Allocator is comprised of costs too disparate and too highly aggregated to be reliable indicia of the proper allocation of marketing costs. [FN311]

194. Several parties propose methods for allocating joint marketing costs that are wholly different from our proposals in the NPRM. Ameritech includes in its proposed manual an apportionment scheme that would identify the incremental costs associated with joint marketing, and would use time reporting to allocate those costs to regulated and nonregulated services. [FN312] IBM proposes that all marketing personnel be 100 percent dedicated to either regulated or nonregulated service, depending on area of expertise. The IBM plan would dedicate support personnel on the basis of primary function. IBM then proposes that exception time reporting be used as necessary.

195. Several commenters contend that the majority of new service offerings will be deregulated, and that these will generate sales revenues and consume marketing personnel time and resources to a greater extent than regulated activities. They argue that this Commission must adopt apportionment schemes that will reflect this disproportionate cost relationship. Florida contends that only costs that can be directly assigned to regulated activities should be borne by the regulated ratepayers, and that all other costs should be allocated to nonregulated activities. [FN313] Several parties argue that positive time reporting (PTR) should be required for all marketing personnel. [FN314] NASUCA, a proponent of mandatory PTR for marketing costs, argues that, if we allow exception time reporting for marketing personnel, we should require that nonregulated operations be the designated activities, and that the exceptions reported should be for time devoted to regulated products and services. [FN315] NASUCA also argues that carriers be required to perform special studies to allocate Account 645 costs between regulated and nonregulated operations. [FN316] Finally, NTCA argues that marketers in small telephone companies find it difficult to allocate or report their time, and that marketing costs should be divided equally between regulated and nonregulated activities. [FN317]

196. c. Discussion. Implicit in the NPRM was the recognition that marketing expenses merit unique treatment because they may have characteristics different from other costs. While the majority of investment-related costs will continue to benefit the carriers' regulated operations, the effort to market new services makes it likely that marketing expenses will benefit nonregulated activities to a disproportionately high degree. This characteristic requires that marketing costs be segregated and apportioned separately. Most of the parties commenting on this issue support our premise that substantial amounts of marketing-related expenses can be

directly assigned or attributed on the basis of objectively verifiable measures of use. We will therefore adopt the apportionment approach proposed in the NPRM. [FN318] We also find, however, that several parties raise legitimate concerns that lead us to modify that proposal.

197. Both BellSouth's and AT & T's arguments indicate a dissatisfaction with the classification scheme established in the Part 31 accounts. Both parties essentially argue that the costs grouped in Accounts 640 to 650 are not sufficiently homogeneous to justify an allocation of residual marketing costs on the basis of the direct assignments and attributions of the costs in those accounts. We find that these arguments have merit, and will modify the NPRM's proposal accordingly. We will not adopt the modifications proposed by BellSouth or AT & T, however.

198. We accept BellSouth's argument that Accounts 648 and 649 do not contain costs that can be considered joint marketing costs. We do not, however, endorse the BellSouth's apparent proposal to remove overhead costs from Accounts 640, 642, 643 and 645. BellSouth has not specifically identified the costs to be removed, and has not explained why such overhead costs as office supplies and repairs should not be allocated between regulated and nonregulated activities. Nor will we accept the BellSouth proposal that Account 643 costs be identified by computing transaction costs, and allocated on the basis of time and motion study results. We believe that the proposed use of transaction cost computations would be subjective and difficult to monitor. In addition, we believe that an allocation scheme that uses three different measures to allocate similar costs is unnecessarily cumbersome. Finally, we note that the BellSouth proposal would use the general allocator to allocate residual Account 642 costs. We disapprove of that practice.

199. We also will decline to adopt the AT & T proposal. That allocation scheme essentially would bifurcate the marketing costs, allocating sales overhead costs according to directly assigned wages, and residual commercial costs according to the aggregate allocation of Accounts 640, 642, 643, 645, 648 and 649. Instead, we are adopting an allocation approach that will respond to the concerns expressed by several commenting parties by redefining marketing costs. This approach will render moot the AT & T proposal, which is based on Part 31 accounts.

200. Upon review of the comments, we find that the NPRM's definition of marketing costs as "the costs recorded in accounts 640-650, excluding 644" to be overbroad. This definition encompasses not only costs relating to public and semi-public phone service, as BellSouth indicates, but also substantial costs related to billing and collections. [FN319] We will therefore redefine marketing costs to ensure that the common costs to be allocated will all be related to the marketing function. In redefining such costs, however, we find it necessary to depart from the Part 31 accounts that were referenced in the NPRM. That Notice was released before the Part 32 accounts were adopted, and reflects the shortcomings of the Part 31 classification system, in which some accounts are characterized by type, while others are characterized by the purpose of the expense. [FN320] The Part 32 accounts are more narrowly tailored to reflect distinct

functional relationships among the costs they record.

201. We therefore define common marketing costs as those recorded in Accounts 6611 (Product Management), 6612 (Sales) and 6613 (Product Advertising). In addition, Accounts 6623 (Customer Services) and 6722 (External Relations) may record costs primarily associated with the marketing function. [FN321] We find that these latter two accounts reflect a level of aggregation too great to allow us to identify the marketing costs that may be included in these accounts. We therefore require that carriers maintain detailed function codes, subaccounts or other subsidiary records within Accounts 6623 and 6722 to differentiate the marketing costs and the non-marketing costs in those accounts. For those carriers that wish to implement cost manuals prior to the effective date of the Part 32 rules, January 1, 1988, the Part 31 equivalents of these costs are those recorded in Accounts 640, 642, 643 and the 644 costs dedicated to "assisting connecting companies in the development of toll business."

202. By adopting this definition, we ensure that all costs defined as marketing costs are functionally related. This action responds to the concerns of BellSouth and AT & T. It also allows us to implement the NPRM's proposal that all residual common marketing costs be allocated on the basis of the directly assigned and attributed marketing costs. Because the costs are functionally related, we can be confident that this allocation of the residual costs will be a reasonable approximation of actual causal relationships.

203. Turning to the arguments raised by the other commenting parties, we will not accept the arguments that residual costs should be allocated on the basis of directly assigned costs alone. It is not clear that carriers will be consistent in identifying costs as directly assignable. Because this determination can be influenced by subjective considerations, there is a possibility that carriers could manipulate the amount and type of costs they identify as directly assignable in order to manipulate the allocator. We will therefore require that all residual common marketing costs be allocated between regulated and nonregulated activities in the same proportion as the directly assigned and attributed costs. If, in the future, we find that the carriers uniformly use direct assignment to allocate the majority of their marketing expenses, we may revisit this conclusion.

204. We also will not accept the proposal that we use the proposed general allocator to apportion common marketing costs. This recommendation received little support and considerable opposition in the comments. In addition, the general allocator, as originally conceived in the NPRM, is being eliminated from the allocation scheme adopted in this Order, in favor of a general allocator that will allocate costs on the basis of total company expenses. See paras. 140-155 infra. Our decision to have residual marketing costs follow the directly assigned and attributed marketing costs will ensure that the cost allocation process reasonably identifies and reflects cost- causing factors.

205. We find that the Ameritech alternative allocation proposal, premised on incremental cost analysis and unit pricing, is wholly incompatible with the allocation scheme adopted in this Order. As such, the proposal cannot be entertained. Similarly, the IBM proposal, requiring 100 percent dedication of all marketing personnel, is fundamentally at odds with the thrust of this proceeding. As discussed in para. 182, supra, 100 percent designation may not be feasible for some job functions. We also find that IBM's suggestion that such assignments be premised on sales personnel's areas of expertise and support personnel's primary functions reflect a myopic perception of personnel functions. A salesperson with an expertise in network applications or switching technology may market either regulated or nonregulated services, and an office worker whose primary function is clerical work could process both regulated and nonregulated paperwork. We believe that the classification scheme proposed by IBM would be difficult to implement and would unduly limit carrier flexibility.

206. We will not accept the proposal to allow only directly assignable costs to be attributed to regulated services. No commentor has made a cogent showing to dispute our statement in the NPRM that carriers may encounter significant costs that cannot practicably be assigned directly. We believe that failure to recognize that regulated activities can generate residual marketing costs would have an unnecessarily punitive effect on carriers. The NASUCA proposal that we require special studies to provide a basis for allocating Account 645 costs has been mooted by our decision to redefine marketing costs. For reasons discussed in para. 184, supra, we believe that requiring marketing personnel to use positive time reporting would unnecessarily limit carriers' discretion to select the time reporting technique most appropriate for the job function. Finally, we find unconvincing NTCA's argument that small telephone companies should be allowed to apportion marketing costs equally between regulated and nonregulated activities. No commentor has shown that such an allocation would be reasonable. Indeed, several parties agree that nonregulated services may command a disproportionately large measure of salespersons' time and related overhead costs.

207. In establishing an allocation scheme for the newly-defined marketing costs, we need to address the issue of the scheme's auditability. As discussed under the section on time reporting, supra, we are establishing certain reporting requirements to enhance our ability to monitor the accuracy of carriers' time reporting systems. Because sales personnel frequently maintain non-routine schedules, we find it necessary to require a greater amount of reporting data for this category of employee. To accomplish this end, we will require all carriers to maintain the documentation required of AT & T marketing personnel in the AT & T Accounting Plan Order. In that Order, we stated that

> In order to determine whether the employee recorded his time correctly, the auditor would need access, not only to the employee himself, but also to the regularly kept, contemporaneous records of the employee's activity during that day. Such records might include telephone logs, appointment logs, and notes kept by employees on the results of

sales calls. Information which might be contained in such records, and which would be helpful in auditing, would include the date and subject matter of a sales contact, the person or persons contacted, and the amount of time spent with the customer or potential customer. [FN322]

208. As stated in the AT & T Accounting Plan Order, if carriers do not currently require such recordkeeping, carriers should describe the actions they will take to satisfy our concerns regarding the auditability of their time reporting systems for marketing personnel. In addition, we will require that such records be maintained for a period of one year.

3. Depreciation reserves

209. a. Introduction. In the NPRM, we expressed our concern that certain characteristics of plant and its corresponding depreciation reserves [FN323] could cause overallocation of depreciation reserves to nonregulated activities. Specifically, we sought comment on whether disparities between depreciation reserve percentages and plant allocation percentages would lead to an inequitable allocation of depreciation reserves. The NPRM defined plant allocation percentages as the extent to which investment in common plant is allocated between regulated and nonregulated services. It was posited that, because nonregulated services tend to use more technologically advanced plant than regulated service, newly-installed plant may exhibit allocation percentages that reflect significantly higher allocations to nonregulated activities than those of older plant.

210. Depreciation reserve percentages were defined as the amount of depreciation reserves accumulated by a category of plant, expressed as a percentage of the total book value of the plant. Because depreciation reserves accumulate every year the plant is in service, older plant in any given investment category has made the largest contribution to the depreciation reserve, and the most recently installed plant has made the least. Thus, older plant necessarily exhibits higher depreciation reserve percentages than newer plant.

211. In the NPRM, we noted that, if older and newer plant is pooled, the combined effects of the allocation and depreciation reserve percentages may result in a misallocation of depreciation reserve. In a situation where old and new plant is commingled, the old plant would exhibit high depreciation reserve percentages, because the annual depreciation amounts had accumulated, and the allocation percentages would reflect a greater allocation to regulated activities, because the older equipment would be used primarily to provide regulated services. Conversely, the new equipment in the pool would exhibit low depreciation reserve percentages, because little depreciation had accumulated for this plant, and would exhibit allocation

percentages that reflect a higher allocation to nonregulated activities. The new plant would therefore make little contribution to the depreciation reserve, but would increase the allocation of the reserve to nonregulated services. This overallocation would understate the net book value of the plant used to provide nonregulated services, and would result in an under allocation of plant-related expenses to those services.

212. In the NPRM, we did not propose any particular treatment of depreciation reserves in light of this concern. Rather, we sought comment regarding the severity of the perceived misallocation problem, and on procedures that would ensure a more reasonable allocation of the depreciation reserve between regulated and nonregulated activities. For reasons discussed below, we find that the Part 32 accounting rules, which will be implemented on January 1, 1988, will segregate plant into accounts and subaccounts that are sufficiently homogeneous to circumvent the potential misallocations that could result from discrepant allocation and depreciation reserve percentages. We therefore find that no action needs to be taken at this time to address the depreciation reserve issue.

213. b. Comments. Several other parties argue that the discrepancy between depreciation reserve percentages and allocation percentages perceived in the NPRM does not present a problem, and will not require special action in this proceeding. [FN324] These parties support their position with a number of arguments. US West asserts that plant is fungible, so no discrepancies between regulated and nonregulated services should emerge. Granite and OPASTCO argue that small telephone companies do not realize the problem to a significant degree. WSTA contends that its accounting system segregates nonregulated plant and maintains separate depreciation expense and depreciation reserve accounts for it.

214. Other commentors proposed a variety of methods to resolve the anticipated disparities between allocation percentages and depreciation reserve percentages. The majority of these parties advocate reclassification of plant into disaggregated, homogeneous units. [FN325] The level of aggregation proposed by these commentors varies considerably, with Idaho suggesting that depreciation reserves be calculated by unit of plant or by highly disaggregated groupings, and NASUCA proposing that we bifurcate plant into new and old technology groups. All of these parties agree, however, in their contention that reclassification of plant into disaggregated, functional groups will eliminate or substantially reduce the threat of misallocation stemming from disparities between depreciation reserve percentages and allocation percentages.

215. Several parties propose that depreciation reserves be maintained by vintage year. [FN326] This approach assertedly would eliminate the depreciation reserve percentages problem by segregating old and new plant. Additional accounting schemes were proposed by BellSouth, which would calculate accrued depreciation by unit of plant using account/vintage reserve ratios, and would allocate the accrued depreciation to Service Categories; [FN327] Ameritech, which promotes a cost manual based on separate books of account and incremental costing; [FN328]

SNET, which would book plant in regulated accounts and require nonregulated services to pay a rate of return to the regulated operations; [FN329] and PacTel, which would use Reserve Reclassification Ratio Tables to compute the reserve amounts allocable to selected plant categories. [FN330]

216. Several parties see in the depreciation reserve issue an opportunity to argue that any depreciation reserve deficiency [FN331] that exists or that may arise should be allocated entirely to regulated activities. [FN332] These parties argue that nonregulated services will be using old as well as new plant, and that the old plant has substantial depreciation reserve deficiencies associated with it. They believe that these deficiencies developed while the old plant was completely devoted to regulated activities, and that the nonregulated services should should not have to bear any of the costs of recovering those deficiencies. They further argue that nonregulated competitors are not encumbered by such regulatory burdens, and that allocating depreciation reserve deficiencies to nonregulated activities would place the carriers' nonregulated activities at a competitive disadvantage. In addition, several parties argue that, in computing all depreciation reserves and depreciation reserve deficiencies, we should use theoretical reserve measures, [FN333] rather than book reserves. [FN334] Conversely, NASUCA supports the argument that book reserves should be used. [FN335] In a related argument, SWB argues that ratepayers have realized the benefit [FN336] of the reserve deficiencies, and, under the decision in Democratic Central Committee, must bear the resultant burden.

c. Discussion

217. We do not endorse US West's argument that plant fungibility vitiates the effects of discrepant deficiency reserve and allocation percentages. US West has not shown that new and old plant are equally fungible, or that they will display similar allocation percentages. Similarly, Granite has failed to demonstrate that small telephone companies are immune from the depreciation reserve problems discussed in the NPRM.

218. While we disagree with these parties' arguments, we reach a conclusion that they promote: that no specific action is necessary to address the depreciation reserve issue at this time. We believe that the implementation of our Part 32 rules will establish a set of functional plant categories and subcategories that will segregate plant at levels much more highly disaggregated than they are at present, and will obviate the need for other action. Under these rules, operating transport and switching plant will be disaggregated into functionally and technologically distinct categories. [FN337] Depreciation reserve accounts will also be maintained at this level of specificity. The segregation of plant on the basis of function and technology will ensure that pooling of old and new plant will be minimized. Because old and new plant will not be pooled to any significant degree, disparities between depreciation reserve percentages and allocation percentages will be eliminated. Thus, the Part 32 accounting rules respond to the arguments of WSTA and the other commentors that promote accounting

segregation of plant and depreciation reserves as a means achieving an equitable allocation of depreciation reserves. [FN338]

219. Of the parties that proposed changes in accounting practices to address the depreciation reserve issue, none specifically discussed the effect of our Part 32 rules. We find, however, that the classification scheme established in those rules occupies a middle ground between the most extreme proposals, and effectively incorporates the central recommendations of the commentors. We will not adopt the Idaho proposal to calculate depreciation reserves by individual item of plant. [FN339] In making this determination, we agree with AT & T that such a highly disaggregated level of analysis would be unworkable. We also will not accept NASUCA's recommendation of a bifurcated categorization approach. We find that segregating plant into new technology and old technology categories would not provide the level of specificity that we require in order to make equitable allocations. We note, however, that the Part 32 rules, by categorizing plant along functional/technological lines, do effect the type of plant groupings that NASUCA envisions.

220. We will not accept the recommendations of parties that proposed classification of plant by vintage year. We find that this system of classification would provide an impracticably large number of cost categories. We believe that the functional/technological classification scheme that underlies Part 32 will result in homogeneous accounts, subaccounts or subsidiary reporting categories that will provide a practical surrogate for vintage year groupings. We also will not accept the recommendations of Ameritech, SNET or BellSouth. These proposals are premised on accounting schemes that employ separate books of account for regulated and nonregulated activities, service categories, unit costing or incremental costing--elements that we have decided not to employ. In addition, we find that the BellSouth and Pac Tel proposals would require a major accounting effort to reclassify extant plant and recalculate extant depreciation reserves on a unit or subcategory level. [FN340] We believe that these approaches would be overly burdensome on this Commission's resources and would not provide a significant increase in accuracy.

221. The arguments that a depreciation reserve deficiency exists and must be attributed to regulated operations are not within the scope of this proceeding, and accordingly will not be considered in this Report and Order. Nor do we accept the recommendations of parties that argue that theoretical depreciation reserves should be used in our calculations. We note that, in its Depreciation Text, NARUC states that "theoretical reserve estimates are very approximate," [FN341] and that it uses theoretical reserves only when book reserve data are not available. [FN342] We concur that theoretical reserves are speculative, and find that the commentors have failed to show any benefit that would compel their use. The reserve deficiency issue has been the focus of several recent Commission Orders, [FN343] and will be resolved in the context of a separate Commission action. We also are not persuaded by SWB's argument that Democratic Central Committee requires that any depreciation reserve deficiencies be allocated to regulated

activities. That case was decided upon facts that are not closely analogous to the instant proceeding.

V. IMPLEMENTATION AND ENFORCEMENT

222. In the NPRM we proposed to enforce our cost allocation standards and affiliate transaction rules by requiring carriers to file for our approval, and keep current, cost allocation manuals demonstrating in detail the application of our standards to their particular operations. These manuals would be subject to public comment and to thorough review by our staff. The results achieved through application of the manuals by the carriers would be subject to audit review by this Commission. We further proposed to augment our own audit capability by requiring each carrier having an approved manual to submit annually the results of an independent attestation audit demonstrating that the manual has been implemented and that the results achieved are reasonable. We also noted that monitoring of cost allocation data by Commission staff was another important aspect of enforcement, and sought comment on the types of data reporting requirements that would enable us to do this.

223. In this part we address each of the three major components of our enforcement scheme: the manual filing requirement, including implementation procedures and timing (Section A), reporting and recordkeeping requirements (Section B), and auditing (Section C). Finally, in Section D, we address the treatment of proprietary information which could become part of this agency's records as a result of the enforcement of our cost allocation rules.

A. Cost Allocation Manuals

1. Filing and review procedures.

224. a. Introduction. In the NPRM we proposed that Tier I LECs and dominant interexchange carriers file cost allocation manuals setting out in detail the manner in which they proposed to implement our cost allocation standards. We proposed that, if we adopted our Alternative 1 standards, the manuals would be organized according to Part 31 accounting classifications. For each account and subaccount, the manual would describe the criteria for identifying directly assignable costs, the allocation pools (cost categories) to which common costs in that account or subaccount would be assigned, and the basis on which the costs in each cost category would be apportioned. We also proposed that the manual include general descriptions of each nonregulated business in which the company is engaged, descriptions of nonfinancial data maintained to implement cost allocations, and descriptions of the methods used by the company to charge direct labor and material. [FN344] A similar manual requirement was proposed for Alternative 2. [FN345]

225. We proposed to require companies currently offering nonregulated activities on an integrated basis to file manuals and to implement those manuals immediately. We proposed that the Common Carrier Bureau conduct an immediate initial review of each manual, with further review, including an opportunity for public comment, to take place after the filing of an initial report from an independent auditor. [FN346] However, in the case of companies subject to separate subsidiary requirements in their provision of CPE or enhanced services, we proposed to require the filing of acceptable cost allocation manuals prior to the implementation of any future decision by this Commission to eliminate the separate subsidiary requirements. [FN347]

226. b. Comments. No party disputes the usefulness of cost allocation manuals in implementing and enforcing cost allocation standards. Most parties other than dominant carriers, however, object strenuously to our proposal to allow cost allocation manuals to be implemented prior to public comment and thorough staff review. MCI characterizes the proposal as procedurally unsound, [FN348] while Ad Hoc finds it "fundamentally objectionable" that carriers might be allowed to operate under deficient procedures for long periods of time with no apparent risk. Ad Hoc notes that small competitors could be damaged by the misallocations that could occur in the year that would elapse between implementation and full scale review of the plan. They argue that, if we do proceed as proposed, we should require carriers to refund misallocations with interest, and not merely to offset future revenue requirements by the amount of the misallocation. [FN349]

227. NATA argues that the carriers should be required to describe their CPE marketing plans in greater detail than they did in their pleadings in Docket 86-79, the BOC Structural Relief proceeding. NATA also presents a scenario for integrating implementation of cost allocation rules with structural relief in the following steps: 1) submission of cost manuals by BOCs; 2) immediate opportunity for public comment; 3) collection of "baseline data" on the BOC CPE operations; 4) final review and audit of the interim cost allocation plan submitted by AT & T in Docket 85-26, the AT & T Structural Relief proceeding; 5) a six month trial run of our cost allocation standards using a smaller independent and AT & T's current unseparated operations; 6) implementation of structural relief for the BOCs.

228. The BOCs, on the other hand, generally favor immediate implementation of their cost allocation manuals and implementation of structural relief prior to final approval of the manuals. [FN350] AT & T suggests that a reasonable compromise between the proposal in the NPRM and delaying structural relief would be to follow the procedures that were used in the AT & T Structural Relief proceeding; that is, implementation after initial review, followed immediately by public comment and more extensive staff review. [FN351]

229. A number of parties have informally raised the question of why we proposed

designing cost allocation manuals based on the Part 31 accounts when Part 32, the new USOA, will be in place by January 1, 1988.

230. c. Discussion. When we originally proposed delaying public comment until a cost allocation manual had been in effect for a year, we did so with the thought that comment would be more informed and focussed, and thus more effective and useful, if commenting parties had access to both the reports that the carriers would file during that year and to the independent audit reports. We also believed that, if we adopted either of the proposed cost allocation alternatives in the form in which it was proposed, and if carriers submitted with their comments draft manuals for both proposals, some manuals that met our standards closely could be reviewed during the course of the rulemaking process. However, the comments of the parties, considered in light of our decision to adopt standards and guidelines which do not closely resemble the manuals submitted by most of the carriers, [FN352] persuade us that public comment should be invited upon carriers' manuals as soon as the manuals are filed. Such comments will be considered before any interim or final approval is granted. Slightly different procedures will, however, be followed for the Independents, for the BOCs, and for AT & T.

231. We also believed, at the time we adopted the NPRM, that the cost allocation scheme we were proposing might be in effect for a year or more before Part 32 was implemented. We always recognized that cost allocation manuals filed under Part 31 would need to be revised to reflect Part 32, and that Part 32 might have to be amended to reflect any accounting changes we might adopt in this proceeding. It now appears, however, that any Part 31 manual filed as a result of this Order will be in effect for less than a year. Therefore, we have couched our discussion of cost allocation standards in terms of Part 32. We are also granting many carriers the opportunity to file Part 32 manuals only, should they so desire.

232. Manual filing procedures for LECs other than the BOCs. As discussed in Part III of this Order, most local exchange carriers ("LECs") will not have to file their cost allocation manuals for our approval. LECs that are subject to the manual filing requirement must file their manuals by September 1, 1987. These manuals will be based on Part 32 accounts. The independents should use the allocation procedures set forth in these manuals in developing the costs they will use to support their October, 1987, access tariff filings. They should, accordingly, implement the manuals on January 1, 1988, concurrently with implementation of Part 32. During 1987 they should continue to use the Fifth Report and Order accounting for nonregulated activities and to allocate costs according to fully distributed costing methods that comply with existing standards. Manuals filed by non-BOC LECs will be made available for public comment immediately upon receipt. They will be reviewed expeditiously by Bureau staff and approved or disapproved by the Bureau acting under authority which we delegate herein. If Bureau action occurs after 1988 access or other FCC LEC tariffs become effective, the LECs will, of course, be obliged to file midcourse correction tariffs to reflect any substantial modifications in the cost allocation procedures.

233. Manual filing procedures for BOCs. BOCs which intend to implement, even to a limited extent, the relief granted in the BOC Structural Relief Order should file their manuals as soon as possible. A company which does not plan to begin unseparated provision of CPE or enhanced services before 1988 may follow the procedures described above for other Tier I LECs. Such a BOC must file a manual not later than September 1, 1987.

234. We anticipate, of course, that most or all BOCs will wish to implement structural relief as soon as possible. We, too, believe that the public will be served by allowing the BOCs to take advantage of the relief we have granted them as soon as is practicable. At the same time, we believe that good cost allocation procedures are critical to the success of the system of nonstructural safeguards we have adopted as a replacement for structural separation. In balancing these concerns, we conclude that we must allow both the public and the Bureau the opportunity to review the BOC cost allocation manuals prior to full implementation of structural relief.

235. We therefore establish the following procedures: BOCs may file their manuals as soon as they wish following the effective date of this Order. These manuals should be based on Part 31 accounting, as amended by this Order. [FN353] Public comment will be solicited immediately upon the filing of each manual. To expedite this process, a BOC should serve a copy of its manual upon the Chief of the Accounting and Audits division of the Common Carrier Bureau and upon this Commission's contract copying service. If the BOC also certifies that it has served its manual upon persons who filed comments in this proceeding, 30 days will be allowed for comment; otherwise, there will be a forty-five day comment period. BOCs will be allowed 15 days to file replies. The Bureau is directed to review BOC manuals expeditiously. If a BOC's manual is approved prior to the expiration of six months after the effective date of this order, it may voluntarily implement the accounting changes adopted in this Order. [FN354] Each BOC must, in any case, file a manual based on Part 32 accounts by September 1, 1987. This filing will be subject to public comment and will be deemed to have been approved unless the staff determines that it differs in substance from the company's previously filed Part 31 manual. A BOC may file a Part 32 manual at the same time that it files a Part 31 manual.

236. Manual filing procedures for AT & T. AT & T has been conducting combined CPE and basic services marketing activities for over a year under an interim plan. If AT & T is allowed to wait until 1988 to implement a cost allocation manual based on Part 32, its interim plan will have lasted longer than we had intended. We therefore require AT & T to file a cost allocation manual conforming to the standards adopted in this Order within 60 days of the release of this Order. AT & T's manual will be made available for public comment when it is filed. Pending Bureau action on its manual, AT & T may continue to use its interim manual, provided it continues to meet the reporting requirements set out in the Bureau's July 11, 1986 Order. AT & T may not, however, expand its joint operations beyond the scope of its interim plan until the Bureau shall have approved its cost allocation manual.

237. Comparably Efficient Interconnection (CEI) accounting plans and protocol conversion joint marketing plans. In the Computer III Phase I Order, we stated that any company which wished to implement collocated provision of basic and enhanced services prior to the development of its Open Network Architecture (ONA) plan could file a CEI plan and an accounting plan based on the proposals contained in the Joint Cost NPRM. After the release of this Order, companies who file CEI plans should file cost allocation manuals conforming to the standards adopted herein, rather than special accounting plans designed for particular enhanced service offerings. Similarly, any BOC filing a waiver petition for permission to market jointly basic packet switching and asynchronous/X.25 protocol conversion should file a cost allocation manual rather than a special joint marketing accounting plan. [FN355]

238. Limited implementation of structural relief. Some BOCs may choose, as did AT&T, to retain their CPE subsidiaries during the initial phase of structural relief, and to limit their combined activities largely to joint marketing and shared administration. Such companies must still file cost allocation manuals, but their manuals may be limited to reflect the scope of their combined activities. For example, a company which does not use network plant for any nonregulated services need not file investment cost pool information for central office equipment and outside plant accounts. However, such companies will have to obtain approval of later changes to their manual prior to expanding their combined activities. [FN356]

239. Shared Administrative Services Plans. The cost allocation manuals which AT & T and the BOCs will file pursuant to the requirements in this Order will supersede the Shared Administrative Services plans which they have previously filed. Carriers should not incorporate those plans by reference into their manuals.

2. Cost allocation manuals: content

240. Cost allocation manuals shall include the following information: [FN357] (A). A description of each of the company's nonregulated activities. (B). A list of all the activities to which the company now accords incidental accounting treatment, and the justification for treating each as incidental. [FN358] (C). A chart showing all of its corporate affiliates, as defined below in Part VI. [FN359] (D). A statement identifying affiliates that engage in or will engage in transactions with the carrier entity and describing the nature, terms, and frequency of such transactions. (E). For each USOA account and subaccount, detailed specifications of the cost categories to which amounts in the account or subaccount will be assigned and of the basis on which each cost category will be apportioned. [FN360]

A. Reporting and recordkeeping

241. In the NPRM we observed that, in a dynamic telecommunications market, it will be important to detect and correct as soon as possible any practices that produce significant

misallocations of common costs. We stated that we intended to monitor closely the results of cost allocations and the growth of nonregulated activities which share costs with regulated services. We invited comment on financial and operating data that we would need to perform this monitoring process, and on the frequency with which such data should be reported to us.

242. A number of parties commented on this topic. These comments will be made part of the record in our Automated Reporting System proceeding, Docket 86- 182. Permanent reporting and data retention requirements will be developed in that proceeding. Interim reporting requirements will be specified for each carrier at the time its manual is approved. We will begin to monitor cost allocation results, and to establish a data base for comparing forecast with actual results, as soon as manuals are implemented. Carriers will, of course, be expected to maintain a complete audit trail of all cost allocations and affiliate transactions.

C. Auditing

1. Independent audit requirement

243. a. Introduction. In the NPRM, we concluded that it would be unrealistic to rely exclusively upon Commission staff audits to enforce our cost allocation policies. Therefore, as an adjunct to an intensified Commission audit program, we proposed to require each company to submit annual reports "of an independent auditor attesting that the company has designed and implemented its cost allocation manual in a manner consistent with regulatory requirements." [FN361] We also stated that "[w]e will expect the auditing firms to examine both the cost allocation manual and the manner in which the manual is implemented, and to express an opinion on whether the carrier is in compliance with our cost allocation and accounting rules." [FN362] Finally, we described the proposed reports as "attest" audits, and noted that standards for such audits were then under consideration by the American Institute of Certified Public Accountants (AICPA).

244. b. Comments. The comments that were filed reflect only limited and qualified opposition to our independent audit proposal. NTCA and Western Union argue that this Commission cannot delegate its responsibility to audit and monitor compliance with cost allocation standards. [FN363] Western Union believes that only Commission audits will be able to ensure compliance because cost allocations involve too many technical issues and too many matters of judgment for this Commission to be able to establish meaningful guidelines for independent auditors. [FN364] NATA and DOJ also stress the importance of Commission audits and express their belief that this Commission does not have sufficient audit resources to satisfy its increasing responsibilities. [FN365]

245. Several parties argue that independent audits are unnecessary, overly burdensome, and should not be required of small exchange carriers. Anchorage argues that local exchange

carriers are already subject to annual independent audits which include cost allocations, and any attest audit requirement would be redundant and impose needless expense on the ratepayer. [FN366] North-West and Rochester also question the need for an additional independent audit in light of the cost and the present extensive federal and state review of carrier books. [FN367] These parties also argue that, to the extent that the auditing costs are allocated to unregulated activities, such costs may prevent the carriers from entering or effectively competing in such markets. [FN368] Finally, several parties argue that small exchange carriers should be exempt from any independent audit requirement, at least in the absence of a problem with a particular carrier. [FN369]

246. The vast majority of the commenters recognize the need for independent audits and generally support the proposal. [FN370] Some of the support, however, is qualified. For example, while U S West recognizes the need for carriers to verify initial compliance, it argues that the requirement for an annual independent audit should last for no more than three years. [FN371] Several commenters question the need for a separate attest audit report, arguing that the attest could be part of the yearly financial audit. [FN372] PacTel believes that a separate detailed attest audit is appropriate for only the first year, while GTOCs advocate combining the attest with the financial audit after the first two years. [FN373] Finally, there is a wide divergence of opinion regarding the proper allocation of the costs of compliance. Various commenters support the assignment of independent audit costs: entirely to regulated activities; [FN374] entirely to nonregulated activities; [FN375] or primarily to nonregulated activities. [FN376]

247. There is widespread agreement among the commenters that the scope and other requirements of the independent audit need further clarification. [FN377] Coopers & Lybrand notes that the AICPA standards cited in the NPRM have now been issued in final form and include two levels of attest assurance, an examination leading to a positive opinion and a review leading to a negative assurance. Coopers & Lybrand states that the NPRM appears to require an examination leading to a positive opinion, but requests clarification. [FN378] Those parties which address the appropriate level of assurance universally favor an examination leading to a positive opinion. [FN379]

248. Coopers & Lybrand also believes that the NPRM fails to provide an adequate definition of the basic purpose and scope of the independent audit. It states that paragraph 54 of the NPRM appears to require a "compliance" audit which would provide an opinion as to the carrier’s compliance with a set of established criteria. However, paragraph 56 of the NPRM mentions compliance with accounting rules, which Coopers & Lybrand characterizes as "tantamount to requiring an audit opinion on compliance with the Uniform System of Accounts and most of Form M." [FN380] Even if this Commission desires to have an opinion only as to the amounts of costs allocated, Coopers & Lybrand argues that the work involved in such an attestation engagement would require several times the effort required for a compliance audit. Coopers & Lybrand argues that such extra work is unnecessary to provide this Commission with

reasonable assurance regarding carrier compliance with the new cost allocation standards. [FN381]

249. Other parties argue that the independent audit should be more extensive than a compliance audit and should also require an opinion as to the appropriateness or fairness of actual cost allocations. [FN382] The statement of Peat, Marwick, Mitchell and Company (PMM), attached as Appendix B to AT & T's Reply Comments, presented the most comprehensive comments regarding the scope and requirements of the proposed independent audit. PMM proposes that this Commission require the auditor to express a conclusion with positive assurance upon three assertions, as follows:

1. The company's cost manual satisfies the requirements set forth by the Commission.
2. The cost system in place in the company accurately reflects the company's cost manual requirements.
3. The cost allocations are appropriate and reasonable in meeting the requirements set forth by the Commission. [FN383]

PMM also makes specific proposals regarding the scope and content of the attest audit and resulting report. [FN384]

250. c. Discussion. We strongly disagree with those parties which characterize our independent audit proposal as delegation of Commission responsibility and otherwise question this Commission's commitment to an adequate monitoring and enforcement program. This Commission is both fully cognizant of and committed to fulfilling its responsibility to monitor carrier compliance with our cost allocation requirements. In the NPRM we clearly indicated that the independent audit proposal was an adjunct to, not a replacement for a Commission audit program. While we will utilize the independent audits in our monitoring program, the final decisions regarding carrier compliance will in all cases be made by this Commission. Thus, we view the independent audits as an important aid in fulfilling our responsibilities, not a delegation of such responsibilities.

251. While, in retrospect, the language used in the NPRM to describe the scope of our independent audit proposal was not as precise as we would have liked, it was never our intention that all carriers, regardless of size, would be subject to the annual independent audit requirement. Rather, consistent with our intention to use such audits in our review of filed cost manuals, we intended the annual independent audit requirement to be applicable only to those carriers that are required to file their cost manuals with the Commission. Since the NPRM proposed the filing of cost manuals only by those carriers which are either Tier 1 local exchange carriers (more than $100 million in total company regulated annual revenues) or dominant interexchange carriers and which engage in unregulated activities, [FN385] our proposal would exempt small exchange carriers from the annual independent audit requirement. From the carrier financial data filed with the Commission, of which we take official notice, it appears that none of the parties opposing independent audits would be subject to such a requirement. Accordingly, we believe that our

decision adequately addresses the concerns expressed by these parties.

252. Virtually all of the carriers that would be subject to our independent audit requirement recognize the need for such audits and generally support our proposal. Many parties argued, however, that the basic purpose and scope of the independent audits need further clarification. The need for clarification is heightened because of our recent decision in the BOC Structural Relief Order, discussed supra. Under our modified cost manual filing and approval requirements, the timing, purpose and scope of the independent audits has necessarily been altered.

253. Our proposal in the NPRM contemplated the filing of the independent audit report within a year after the filing and implementation of the cost manuals, and annually thereafter. [FN386] We also proposed that the audit report attest that the carrier has designed and implemented its cost allocation manual in a manner consistent with regulatory requirements. [FN387] Under the NPRM proposal, which would have allowed the implementation of cost allocation manuals and the elimination of structural separation without prior Commission approval of a cost manual, the annual independent audit requirement was properly viewed as a device to aid this Commission in our detailed compliance review and, thereafter, to provide some assurance regarding continuing compliance. However, since cost allocation manuals must now be approved prior to the elimination of structural separation, and since all substantive amendments to approved manuals must also be approved prior to implementation, the value of an attestation regarding cost manual compliance has been greatly reduced, if not eliminated. We must decide whether a cost manual complies with our requirements prior to approval, and we do not believe that the opinion of an independent auditor regarding the ultimate legal conclusion at issue would add significantly to the record for such decision. Thus, we do not believe that the costs that would be imposed by requiring a cost manual compliance attestation are justified, and we have decided not to adopt that proposal.

254. On the other hand, we believe that our proposed requirement for attestation regarding proper cost manual implementation has continuing validity. As we stated in the NPRM, the real test of our rules and the carriers' cost allocation manuals "will be the reasonableness of the allocations which result from applying those rules and procedures." [FN388] Our proposal for proper implementation attestation was premised upon our belief that even a cost manual in complete compliance with our requirements will not produce reasonable results absent proper implementation. Our belief in this regard remains unchanged. In addition, we do not believe that proper implementation of an approved cost manual can be judged without direct observation and analysis of the carrier's financial operations. Since this Commission does not have the auditing resources to perform an on-site examination of the implementation of all approved cost manuals on an annual basis, we believe that a requirement for an annual independent auditor attestation of proper implementation is both necessary and, indeed, indispensable to an effective monitoring and enforcement program. Finally, the comments

submitted have convinced us that it would be possible, without prohibitive cost, [FN389] for the independent auditors to attest to the reasonableness of the carrier procedures to implement cost allocations. [FN390] Furthermore, we believe that the cost of such yearly attestations is justified because both the independent attestation and the underlying documentation will be invaluable to this Commission's cost allocation monitoring activities. [FN391] Accordingly, we will require that the annual audit report also attest to the accuracy of the carrier's cost allocations as reported to this Commission.

255. For the reasons stated above, we have decided to modify our independent audit proposal. Carriers that are required to file their cost allocation manuals with this Commission will also be required to comply with the following annual independent audit requirements.

256. After Commission approval of a carrier's cost allocation manual, such carrier shall, on an annual basis, [FN392] file the report of an independent auditor attesting that: (1) the cost system in place in the company reflects the company's cost manual requirements; and (2) the cost allocations performed in accordance with that system are the product of accurate methods. The level of attest assurance shall be an examination leading to a positive opinion and shall include:

(1) A compliance review attesting that a costing system is in place in the company which appropriately reflects the company's cost manual and that the results furnished in any required reports to this Commission are an accurate reflection of the data produced by the cost system. This review need not test data sources for accuracy but would comment on the reasonableness of such data sources in providing costing information.

(2) An identification of underlying data sources and the provision of: (1) an evaluation of the criticality and materiality of each data source to the results of the cost allocation report. (2) a workplan describing the activities and estimated hours required to express a positive opinion on the reliability of each data source; and (3) a description of the major data sources selected for examination. This selection would consider such factors as materiality, length of time since the last review, changes that have been made in the system and overall assessment of vulnerability.

(3) An examination of the data sources selected.

257. The independent auditor's report filed with this Commission shall include:

(1) The scope of the work conducted, specifying the items examined and the extent of the examination.

(2) The auditor's conclusion as to whether the actual methods and procedures implemented and performed by the company conform with the objectives, approach and

procedures described in the cost manual.

(3) Any material exceptions or qualifications the auditor may have identifying the adequacy of the procedures.

(4) Any limitations of scope imposed on the auditor by the company or other circumstances which could have an impact on the auditor's opinion.

(5) A statement that the Attestation Standards have been fully met during the examination.

258. As noted above, there was wide divergence of opinion as to whether the costs incurred to comply with the annual independent audit requirements are properly allocated to regulated or to nonregulated activities. We view this debate essentially as a chicken or egg question which has no completely satisfactory solution. We do not believe that a direct assignment of the entire cost of the independent audit to either regulated or nonregulated operations would be appropriate. We are also unaware of any acceptable attribution factor to support an indirect assignment of such costs. Accordingly, unless a carrier is able to demonstrate that there is an appropriate attribution factor to support an indirect assignment, we believe that the auditing costs should be allocated according to the general composite allocator for expenses.

259. Finally, in light of our modified independent audit requirements as set forth above, we do not agree with the suggestion that annual audits should not be required for more than two or three years. The audit requirements we have adopted are not limited in utility to initial compliance determinations but rather will be an important part of this Commission's continuing cost allocation monitoring activities. Clearly, no present limitation on the duration of such requirements is warranted.

2. Designated auditor

260. a. Introduction. In the NPRM we cited the 1983 GAO report for its observation that "... one potential drawback to reliance on independent audits is the perception that auditors hired by the company may not be wholly objective." [FN393] We sought comment on whether the reliability and usefulness of independent audits could be improved if this Commission designated which firms could be used for the required audits. We proposed to grant designated auditor status freely "... subject to revocation in the event that a firm's audits prove biased or unreliable." [FN394]

261. b. Comments. The designated auditor proposal was generally supported by the states, by user and consumer groups, and by CPE and enhanced service providers. [FN395] Such

support is premised upon the belief that there are inherent conflicts of interest which jeopardize reliability if the attest auditors are selected and paid by the carriers. Western Union notes that, unlike financial auditors, attest auditors would not be subject to potential shareholder liability as an incentive to auditor objectivity. It argues that absent such constraints, carrier compensation of the auditor reviewing cost allocations presents a built-in conflict of interest which would jeopardize reliability. [FN396] Similarly, IDCMA argues that the attest auditor would have responsibility to this Commission and not to the carrier management or shareholders, so an auditor could not perform both an attest and a financial audit for the same carrier without a conflict of interest. [FN397] Finally, California argues that some auditing firms have extensive telecommunications auditing and consulting business and are unlikely to advocate a position which adversely affects the telephone industry. [FN398]

262. Our designated auditor proposal, a listing of eligible auditors with possible revocation of such status, would be sufficient to satisfy the objectivity concerns of some of the supporters. [FN399] However, other parties suggest various alternative or additional mechanisms to further enhance the reliability of the attest audits. For example, California advocates the auditing of cost allocations by each state commission. Only if a state chooses not to audit should an independent auditor be used, and then the state should have first priority in deciding which auditors can be used. [FN400] Tennessee argues that this Commission should employ the independent auditors in order to establish appropriate responsibility and eliminate compensation conflicts of interest. [FN401] Various parties argue that this Commission, not the carrier, should select the auditor, perhaps through a competitive bidding process or a lottery. [FN402] As an additional safeguard, some parties argue that in order to be considered eligible to perform an attest audit the auditor should be precluded from doing other work for the carrier to be audited [FN403] or even other work for all utility clients. [FN404]

263. The BOCs, ITCs and various other commenters oppose any program that restricts management discretion in selecting an independent auditor. These parties vigorously dispute the premise that the objectivity of independent auditors would be somehow compromised by other work that such auditors perform for carriers or by compensation arrangements. [FN405] Arthur Andersen asserts that "[t]he underlying tenet of [the auditing] profession is one of independence in expressing its opinion." [FN406] That basic tenet is supported by a variety of professional and ethical standards requiring independence which auditors are bound to observe. These requirements include General Standard No. 2 of AICPA's Statement of Auditing Standards and Procedures and General Standard No. 4 of AICPA's Statement on Standards for Attestation Engagements. [FN407] In addition, Coopers & Lybrand notes that:

> AICPA includes in its Code of Professional Ethics a comprehensive set of rules and interpretations requiring AICPA members to avoid situations that would create conflicts of interest, or bias, either in appearance or in fact. Compliance with the Code is mandatory and instances of abuse are rare. [FN408]

Finally, auditors of public companies, which include all major telecommunications companies, are also subject to the extensive rules and regulations of the Securities and Exchange Commission regarding the independence of auditors. [FN409]

264. In addition to the professional and ethical standards noted above, Arthur Andersen asserts that there is precedent for governmental reliance on the independence of auditors performing attest services. Arthur Andersen notes two examples, involving Federal grants and the annual reporting requirements of the Federal Energy Regulatory Commission. In both instances the independent auditors perform attest services in addition to financial statement audits for the same company. [FN410] In light of the applicable standards and the experience of other governmental agencies, the opponents of a designated auditor program believe that there is no factual basis to question the independence of auditors or their ability to perform reliably attest services in addition to other auditing services. [FN411]

265. Commenters opposing the designated auditor proposal also argue that it would be very costly and inefficient to preclude a carrier from using its present financial auditor for the attest audit. [FN412] Coopers & Lybrand argues that:

If a "designated auditor" program were to preclude a company from using its present financial auditor, there would be increased costs to consumers and, quite possibly, a level of reduced audit quality due to less knowledge of the company's procedures by the auditor. The financial systems that would typically support the cost allocations described in the NPRM are an integral part of the company's overall financial information system, of which the present auditor has extensive knowledge. The requirement that a new auditor learn these systems would impact both cost and quality. Also, the separation of costs between regulated and nonregulated activities will be of interest to the financial auditor and a second auditor would lead to duplication of effort. [FN413]

Consideration of the applicable auditing standards and the inefficiencies noted led US Sprint to change its position and conclude that our designated auditor proposal may not be necessary. [FN414]

266. Numerous parties question the efficacy of the designated auditor proposal and note various procedural problems that such a program would raise. Various parties argue that if freely granting designated auditor status enables any auditor to be qualified simply by asking, then there is no need for such a program. [FN415] If, on the other hand, not all auditors could qualify, this Commission would have to establish criteria and procedures for qualification, revocation, appeals and reinstatement, tasks which would outweigh any benefits. [FN416] DOJ also opposes the designated auditor proposal as an unwarranted limitation on competition among auditors. [FN417] The opponents generally argue that unacceptable audit results can be more effectively and efficiently handled on a case-by-case basis. [FN418]

267. Finally, while opposing the designated auditor proposal, several parties suggest alternatives to enhance the reliability of the attest audits. For example, noting the technical complexity of the cost allocations involved, several parties argue that the attest auditors should be required to demonstrate their technical proficiency to this Commission. [FN419] Florida suggests mandatory participation in approved peer review programs. [FN420] Finally, several parties suggest that this Commission routinely conduct oversight and quality control reviews to evaluate the attest audits. [FN421]

268. c. Discussion. Contrary to the impressions expressed by a number of parties, it was not our intention in the NPRM to question the independence of the auditing profession. Nor did we intend to engage in any direct regulation of the auditing profession. Rather, in the NPRM we noted a "perception" of a lack of auditor objectivity, and we sought comment on whether a designated auditor program could improve the reliability and usefulness of the independent audits. We did not propose to choose or directly assign auditors to perform the required audits. Rather, we proposed to grant designated auditor status freely, subject to revocation in the event of demonstrable bias or unreliability.

269. Our designated auditor proposal was successful in stimulating a healthy debate regarding the reliability and usefulness of independent audits. The comments, both pro and con, were extremely helpful in our evaluation of an issue we believe to be crucial to the success of our cost allocation program. After careful review of the extensive comments presented, we have concluded that neither our designated auditor proposal nor the more restrictive proposals presented by some parties are necessary to ensure auditor objectivity and the reliability of our required independent audits.

270. The support of our designated auditor and other alternative proposals is premised upon perceived conflicts of interest arising from auditor/carrier business relationships or compensation arrangements. Such perceived conflicts are argued to compromise auditor objectivity, thus jeopardizing the reliability of the independent audits. However, while some parties may perceive such auditors to be less than completely objective, we can find no evidence in the record that such perception is based in fact. To the contrary, we believe that the opponents of our proposal have persuasively demonstrated that the numerous professional and ethical standards applicable to auditors are sufficient to ensure the objectivity of independent auditors. Our conclusion is supported by the evidence of general compliance with the applicable standards and by governmental and public reliance on financial and attest audits, even though the auditors have other business relationships with and are compensated by the audited companies.

271. In light of our conclusion that we can rely upon the objectivity of independent auditors, we find ourselves in agreement with those parties who argue that there is no need for a formal designated auditor program in which any auditor can, simply through request, achieve designated auditor status. Nor do we believe that it is necessary or appropriate for us to establish

restrictive standards regarding technical proficiency which would limit the pool of, and competition among, auditors eligible to perform the attest audits. This Commission does not belong in the business of regulating auditors, and AICPA's attest audit standards specifically require technical proficiency regarding the subject matter of the audit. [FN422]

272. In addition, the evidence of record is insufficient to justify the substantial costs (direct, indirect and administrative) which would be incurred to implement the proposals aimed at eliminating all perceptions of lack of auditor objectivity. The evidence is persuasive that the elimination of perceived conflicts of interest through Commission choice of auditors or through precluding all other business relationships with the audited carrier would be likely to result in an expensive duplication of audit work and a lack of familiarity with carrier costing procedures that could jeopardize reliability. Such programs would also require the fashioning of additional administrative standards and the further burdening of our administrative resources in the administration of such standards. Absent the possibility of resulting significant improvements in reliability of the audits, which the record does not support, such additional costs and burdens will not serve the public interest.

273. However, we believe that some restriction on the carriers' choice of independent auditors is warranted. As noted above, we have decided that the annual independent audit must attest to the proper implementation of the carrier's approved cost allocation manual. We believe it to be likely that some carriers will contract with an independent auditor for consultation regarding such implementation. Given the critical importance of the annual attest audit, we do not believe that it would be appropriate for an independent auditing firm to both consult on cost manual implementation and then attest that such implementation is proper. It may well be that the AICPA Code of Professional Ethics would preclude auditing firms from performing such a combination of services for a single carrier. In any event, it is our view that such a combination of services would present a situation involving the appearance of a conflict of interest or bias. In addition, we believe that implementation consultation is the type of service that can be effectively provided by any auditing firm offering management advisory services, so there is no compelling reason to permit the carriers' financial auditors to provide implementation consultation. Accordingly, we will not permit a carrier to use the same auditing firm for both cost manual implementation consultation and the required annual attestation of proper implementation.

274. Although this Commission will not designate the auditors who may be used, our own staff will, of course, be examining cost allocation procedures as well as other accounting procedures in the course of regular carrier audits. In a sense we will be auditing the auditors and can take appropriate corrective action if we have reason to believe that a particular auditor has not performed its task in an objective and competent manner.

D. Proprietary Information Issues

1. Introduction

275. In the NPRM we solicited comment on what financial and operational data we would need to monitor cost allocations, and on the frequency with which such data should be reported. [FN423] We also proposed to require that the companies submit the management letter with the audit report and that the independent auditors make their workpapers and all other documentation available to this Commission upon request. [FN424] Both of these proposals generated comment about the extent to which data concerning carriers' nonregulated businesses might be made available to the public as a result of such data becoming part of this agency's records.

2. Comments

276. Virtually all of the commenting BOCs and ITCs express concern that cost allocation data that is reported to this Commission, particularly data concerning unregulated activities, will contain proprietary information which should be protected from release to the public. [FN425] Many of the BOCs argue that reported data regarding their unregulated operations should be aggregated and not service specific in order to protect such proprietary data. [FN426]

277. PacTel argues that auditor workpapers are proprietary, and that our proposal would violate the auditor/client relationship unless information requests are made directly to the carrier so that appropriate steps can be taken to protect against the release of confidential information. [FN427] SWB argues that auditor workpapers are considered to be trade secrets and notes that a statutory accountant/client privilege has been enacted in some seventeen states. [FN428] Various parties also oppose the submission of management letters, noting that there is no requirement for such letters to be prepared in connection with every audit and arguing that such letters are confidential communications regarding non-material issues and recommendations for accounting system improvements. [FN429] The opponents generally argue that this Commission's existing rules regarding the protection of proprietary information would prove to be too unwieldy to provide proper protection for workpapers and management letters submitted to this Commission because of the inevitable multiple requests for confidentiality and associated litigation. [FN430] Thus, the opponents argue that workpapers should only be available to Commission staff, and that on-site inspection would be the preferred method to ensure confidentiality. [FN431]

278. Some parties which support our data submission proposals note that accounting regulation is necessarily more intrusive and requires greater scrutiny of nonregulated operations than structural separation. [FN432] They argue that the carriers, having sought separate subsidiary relief, should not now complain about the consequences of accounting separation. [FN433] They conclude that if accounting separation causes carriers to reveal proprietary information to an extent they find unacceptable, the carriers can always keep such information

confidential by engaging in unregulated businesses only through a separate subsidiary. [FN434]

279. Most of the comments advocate maximizing public availability of carrier cost allocation data while also recognizing that some truly proprietary information should be protected. [FN435] These commenters argue that public access to cost allocation data is necessary in order: (1) to provide assurance that costs are properly allocated; [FN436] (2) to assist this Commission and the state commissions in scrutinizing rate filings; [FN437] (3) to increase carrier accountability; [FN438] (4) to utilize this Commission's complaint process effectively; [FN439] and (5) to provide an additional check on strategic behavior. [FN440] Unlike the BOCs, most commenters who advocate public disclosure believe that this Commission's existing rules would suffice to protect truly proprietary data from unwarranted public disclosure, [FN441] or argue that this Commission can adopt appropriate procedures to protect proprietary data. [FN442] These commenters stress that the carriers should bear the burden of proving that information submitted is indeed proprietary. [FN443] In this regard, NASUCA proposes that all information should be presumed to be non-confidential, and that this Commission should establish a ten day period during which petitions requesting confidential treatment can be reviewed by the Chief of the Common Carrier Bureau. [FN444]

280. A number of parties state that Commission access to auditor workpapers and other documentation would be valuable. [FN445] The same is true of the commenting accounting firms. None of those firms opposed Commission access to their workpapers. [FN446] However, Florida observes that workpapers are the property of the auditor and that workpapers are generally not subject to scrutiny without the consent of the client. Accordingly, to ensure Commission access, Florida suggests that this Commission "require the auditor, as part of the contractual agreement with his client (the company), to make his working papers available to the Commission upon request." [FN447]

3. Discussion

281. In Section B, above, we decided to consider permanent reporting requirements in our Automated Reporting Requirements proceeding, and to institute interim reporting requirements for each carrier at the time that we authorize implementation of its manual. We will also defer addressing any proprietary information issues raised by routine reporting of cost allocation data until reporting requirements are established.

282. Parties opposing our proposal that the management letter be submitted to this Commission and that the independent auditors make their workpapers and all other documentation available to this Commission upon request argue that the auditor/client relationship and some state statutory privileges preclude or protect the release of auditor workpapers absent consent of the client. In view of the purposes of this particular audit, neither the carrier nor the independent auditor will be permitted to invoke such a claim of privilege to deny our auditors

access to the workpapers or other documentation. Any conflicting state law requirement must be superseded in order to enable this Commission to perform its functions under the Communications Act.

283. We believe that an effective Commission cost allocation monitoring and enforcement program is dependent upon both the required independent audits and the availability to Commission staff of all relevant data. We also believe that auditor workpapers and management letters, when they are prepared, will contain information which should be available to this Commission. On the other hand, we do not believe that a requirement that carriers file such materials with this Commission would be consistent with the Congressional solicitude for the protection of audit documentation from general public disclosure expressed in Section 220(f) of the Communications Act or with the level of protection of proprietary data necessary to ensure the continued cooperation of carriers in an effective monitoring program. Accordingly, we have decided to adopt Florida's recommendation that we mandate a contractual access provision. Therefore, all contracts for the provision of attestation services must contain the following provision:

> The parties to this contract recognize that the attestation audit contracted for is a requirement mandated by the Federal Communications Commission (FCC) to assist in the monitoring and enforcement of the FCC's cost allocation requirements. The parties also acknowledge that the FCC has determined that FCC staff access to the auditor's workpapers is essential to the FCC's satisfaction of its monitoring and enforcement responsibilities. Accordingly, in the event of an FCC staff audit, the carrier to be audited and the auditor hereby expressly agree to provide FCC staff access to auditor workpapers prepared in connection with the execution of this contract.

VI. AFFILIATE TRANSACTIONS

A. Introduction

284. In the NPRM, we proposed to amend the USOA to add a new Section 31.01-10 to the general instructions regarding transactions between the regulated entity and its affiliates. [FN448] We noted that we have long been concerned with the potential for cross-subsidization that exists when a regulated company deals with non-regulated affiliates in non-arms length transactions. We had not previously adopted rules in this regard, other than the requirements in the Second Computer Inquiry that transactions between a regulated company and its Computer II affiliate be reduced to writing and filed with this Commission. [FN449] Rather, we have relied upon the ratemaking process to examine the reasonableness of transactions between the carriers and their unregulated affiliates to insure that ratepayers do not bear costs which are excessive or otherwise properly borne by the carriers' other customers. See, e.g., AT & T (Docket No. 19129), 64 FCC2d 1, 43 (1977) (concern about reasonableness of prices set unilaterally by Western Electric for sales to the BOCs).

285. The proposed rule would require that all transactions between the regulated entity and its affiliates be recorded at market price, provided that those prices can be determined from prevailing price lists held out to the general public in the normal course of business or from tariffs on file with a regulatory commission. However, if prices can not be determined from prevailing price lists or tariffs, another standard would be applicable, and the price on the recorded books might vary according to which entity received the asset or performed the service. If the regulated entity purchased the asset or service from the affiliated entity, the cost recorded on the regulated books would be the lower of the cost to the originating activity less all applicable valuation reserves, or the fair market value. However, if the asset or service were sold by the regulated entity to the unregulated affiliate, the sale would be recorded on the regulated books at the higher of cost less valuation reserves, or estimated fair market value.

286. We also addressed the allocation of income taxes between the regulated and unregulated entities, and proposed that the income tax recorded by the regulated entity be the same as if it had been separately determined for that entity. However, tax credits generated by the carrier's operations would be recorded by the carrier when used in the settlement of taxes by the affiliates regardless of whether the carrier would have been able to use the credits itself as an independent entity during the applicable period.

B. Comments

287. Many parties generally support our proposal for transactions between a regulated entity and its affiliates. [FN450] However, some of those parties which support the proposal urge us to clarify certain portions. A question raised by several parties was whether we intended that the rule apply only to transfers between separate companies. These parties urge us to clarify the rule so that it would apply to transfers between the regulated and unregulated sectors of a regulated company. [FN451]

288. Other parties, primarily the regulated carriers, object to the proposed affiliate transaction proposal. They raise a variety of alleged flaws in our approach, especially with respect to the "double standard" for valuation depending on whether the regulated entity purchases or sells an asset or service in the absence of a tariff or price list. [FN452] AT & T claims that the proposal violates the principles set forth in Democratic Central Committee [FN453] because ratepayers, in its view, are not entitled to gains on the transfer of assets unless they bore the risk of loss of those assets. [FN454] Other carriers claim the proposal is unfair and demonstrates general bias in favor of regulated operations. [FN455]

289. Among the other objections to our proposal is that this Commission need not adopt any rules at all on this subject, as the ratemaking process at the state and federal levels will insure that transactions between affiliates are not burdensome to the ratepayers. Parties which

advocate this position also point to possible conflicts between federal and state policies and statutes. [FN456] Our proposal to use fair market value was criticized by some commenters, on the basis that it is too subjective and difficult to establish. [FN457] The major suggested alternatives were: (a) use of estimated market price for all affiliated transactions, whether such transfers be in or out of regulation; (b) recovery of the selling party's cost, whether or not the transfer is in or out of regulation; and (c) cost plus a reasonable return. [FN458] Finally, the proposal was criticized as discouraging a carrier from taking advantage of bulk purchasing by an affiliate. US West, for example, observes that combined purchasing through procurement affiliates can provide the regulated companies with large volume discounts, thus reducing the costs of such purchases to a point below that which each entity alone would pay. It suggests that our proposal would negate any profits to be made by the procurement subsidiary, and that there would be no incentive to undertake combined purchasing. [FN459]

C. Discussion

1. Need for affiliate transaction standards

290. Our goal in establishing standards for transactions between affiliates is to prevent cost shifting to ratepayers by means of improper transfer pricing. The Department of Justice, in its Comments (at pp. 38-9) states the concern succinctly:

> If a firm produces nonregulated inputs needed to produce its regulated products, it has an incentive to cross-subsidize by selling itself those inputs at prices higher than the cost of producing them. This would increase the "cost" of the regulated product, but it would also increase the firm's total revenues because, under cost-based regulation, the regulators would permit a corresponding increase in the price of the regulated product. The carrier, therefore, would retain on the nonregulated side the higher profit resulting from the above-cost price paid by the regulated firm to its affiliate. Conversely, if assets or services of a regulated business are sold to a nonregulated affiliate at too low a price, profits on the nonregulated side will increase. The loss to the regulated business will increase the service's revenue requirement and be recovered from ratepayers. (footnote omitted)

291. Some parties argue that we need not adopt any transfer standards herein. This position is not consistent with our need to have an effective system for separating the costs of regulated and nonregulated activities. In fact, the absence of such standards would create a loophole that would call into question our ability to regulate. It is no answer to oppose the proposed transfer rules because it appears not to be "practical" to rely on estimates of fair market value (Pacific Comments at 33). Although, as we note herein, determination of fair market value raises concerns of subjectivity, a failure to establish any standards undermines our ability to detect and require correction of possible cross-subsidization.

292. Arguments against the implementation of rules governing transactions between

affiliates appear to rely on the theory that we are simply adding another layer of regulation on an area now subject to regulatory oversight, that we are being "intrusive" or that we have no authority to prescribe accounting practices for the unregulated entities which do not follow the USOA. [FN460] We have, however, emphasized in the proceedings leading to elimination of the structural separation requirements imposed in the Second Computer Inquiry that accounting safeguards are essential to the operation of the BOCs and AT & T in unregulated markets. [FN461] The affiliated transactions requirements are a key part of our deregulatory effort and should be a small price for the carriers subject to our jurisdiction to pay in this regard. [FN462] Some parties observe that because the unregulated affiliates do not follow the USOA, we should not adopt rules herein. We see no reason why the proposed rules will produce "unrealistic and incomparable results," as NYNEX suggests (Comments at 42). By our action here we prescribe only rules for recording certain transactions on the carriers' regulated books.

2. Consistency with state regulation

293. Rochester suggests that we defer to the states in this area, citing statutes and regulations which govern its dealings with affiliates. [FN463] Other parties cite similar activities at the state level, and urge that we carefully structure any rules to insure that we do not interfere with state interests and statutes. [FN464] We do not believe that our actions herein will interfere with state ratemaking interests. As we have noted in our discussion of jurisdiction (see paras. 82 to 93, supra), we are not limiting the states in the way in which they regulate the intrastate rates of the subject carriers. In setting intrastate rates hereafter, the state regulatory commissions may, as they now do, take into account transactions with affiliates.

3. Affiliated transactions for services and supplies

294. Our review of the comments herein convinces us that this Commission should distinguish between asset transfers and the provision of services and supplies. Commenters have suggested that the inclusion of these latter activities in the proposed rule would discourage, if not eliminate, the incentive for certain service activities to be provided in a more efficient manner than that which the regulated entity would alone achieve. [FN465] Also, if the regulated entity undertakes joint services which benefit unregulated operations, it would not be clear whether the regulated entity should follow its cost allocation manual or the rules for affiliated transactions.

4. Valuation of assets transferred between affiliates

295. There is widespread support in the comments for our proposal to use fair market value as the criterion for valuing assets [FN466] which are transferred from a regulated entity to an unregulated affiliate, or vice-versa. The controversy arises when "fair market value" can not be determined in the manner which we proposed in the Notice: by reference to prevailing price lists held out to the general public in the normal course of business or to filed tariffs. We

believe that this approach remains the preferred method of valuation, and that other methods do not provide us with the assurance that asset transfers protect the ratepayers from bearing unreasonable charges. AT & T suggests that fair market value is best determined from actual market transactions rather than from price lists held out to the general public. [FN467] This approach affords the carrier a degree of subjectivity in selecting the "actual market transaction" for the asset transfer, and as such detracts from our ability to monitor the carrier's asset transfers. We also find unpersuasive the argument that the valuation should, in the absence of a tariff or price list, always be "cost, which includes a reasonable profit." (Centel Comments at 15.) The cost may bear little resemblance to the asset's actual value, such as land and buildings in downtown locations. [FN468] Moreover, the failure to recognize fair market value in transfers out of regulation in the absence of tariff or price lists would not comply with the principles of Democratic Central Committee. See para. 301, infra. [FN469]

296. We have also considered the arguments of the carriers that it is inequitable to adopt a "double standard" for valuation of assets, depending on whether the regulated entity receives or transfers the asset. These commenters urge us to use the same valuation method regardless of the direction of the transfer. We do not find this position convincing. Our proposal was designed to insure that the ratepayer receive the benefits associated with the appreciation of value of assets which are transferred to unregulated activities. However, it is also necessary to ensure that assets not be transferred to the regulated entity after they have served their purpose in unregulated activities unless the ratepayers benefit from the depreciation which has been charged. We would be remiss if we established a rule which gave the carriers complete discretion to transfer assets in or out of regulation without regard to the impact of the prescribed valuation on the regulated activities. The incentive certainly would exist for them to transfer into the regulated activities assets with a high market value that are of little use to ratepayers.

297. The procedure which we are adopting is fully consistent with the principles established in Democratic Central Committee. [FN470] That case holds that ratepayers are entitled to receive the profits on the transfer of assets out of regulation if they bore the risk of loss on those assets. That principle forms the basis of our rule regarding assets transferred from the regulated entity to its affiliates. The holding does not, however, require that property held by the unregulated affiliate be transferred at market value if that value exceeds the cost less valuation reserves. [FN471] We believe that, in general, carriers have an incentive to overvalue such assets. The rule we are adopting protects ratepayers from that form of abuse. We do realize that an unusual circumstance could arise in which ratepayers would benefit from a transfer that an affiliate would be willing to make at a price somewhere above net book cost but below market value. In such a circumstance, we would consider a waiver request so that the regulated entity may record the asset on its books at a price which works no hardship on ratepayers.

298. We also take this opportunity to clarify our proposal with respect to the nature of asset transfers. As noted above, various commenters suggested that the transfer rule should apply

not just to transfers between separate companies, but as to all transfers between the regulated entity's regulated and nonregulated accounts. That was our intent and we have modified the language of the affiliate transaction rule to make that intent more clear. [FN472]

5. Valuation of services provided to or by an affiliate

299. If the carrier provides a service to an affiliate pursuant to a tariff, including a tariff filed with a state commission, the affiliate will, of course, pay the tariff charge and the actual revenues will be recorded. Services that an affiliate actually provides to unaffiliated persons or entities will also be paid and recorded at the market rate. When affiliates provide shared services to each other that are not being provided to unaffiliated persons or entities, the costs must be apportioned in a manner that complies with the standards and procedures for the apportionment of joint or common costs between the regulated and nonregulated operations of the carrier entity.

6. Allocation of income taxes

300. We proposed in the NPRM a procedure for allocating income taxes between the regulated entity and its affiliates. Few parties commented on this proposal, and we will include it in the rules adopted herein. Our procedure appears to be consistent with current allocation procedures of some states. [FN473]

7. Other affiliated transaction concerns

301. The Department of Justice apparently reads our NPRM to require that all transactions between a carrier and its affiliates be reduced to writing and made publicly available (Comments at 41, n. 71). We did not intend such a procedure. The procedures which we have established with respect to the cost manuals will require the submission of certain contracts with affiliates, but asset transfers alone need not be publicly identified by routine filings with this Commission. In our enforcement procedures and audits we will have opportunity to review all such transfers as necessary, and we expect that the carriers will retain sufficient documentation to allow us to assess the propriety of the transfer.

VII. ACCOUNTING ISSUES

1. Introduction

302. This Section will discuss our existing rules for accounting for nonregulated activities, our NPRM's proposals, and the treatment of dedicated and common investment and related expenses that we intend to adopt.

303. In the Fifth Report and Order, we prescribed Part 31 accounts for nonregulated

activities, and we adopted definitions of "nonregulated activities" and "regulated telephone services." Under this system, costs associated with nonregulated activities are initially recorded directly in the nonregulated set of accounts or in accounts for regulated operations, depending on the nature of the cost and on how the cost is incurred. All nonregulated costs which are initially recorded in accounts for regulated operations, except for costs representing the nonregulated share of investments in items of common plant, are transferred to Account 106, Nonregulated Investment, at the end of each month. The effect of the above accounting is to require the carriers to establish separate accounting divisions or entities for those nonregulated activities which are not conducted through separate corporate entities. The Fifth Report and Order, however, left unspecified the mechanism by which portions of common plant allocated to nonregulated service would be removed from the ratemaking process.

304. In the NPRM, we sought comment on two alternative methods of separating common costs between regulated and nonregulated activities. Alternative 1 would follow the accounting established in the Fifth Report and Order, i.e., all revenues, expenses, and investments attributed solely to nonregulated activities would be recorded in separate non-operating accounts; the nonregulated portion of common expenses recorded initially in the operating accounts would be removed from those accounts and debited to Account 106 and would be simultaneously recorded as expenses in the separate nonoperating accounts; and all investment in common plant would be recorded in regulated plant accounts, with the nonregulated activities compensating the regulated activities for use of common investments. The amount of compensation would be computed by applying the authorized rate of return and income tax factors to the portion of the common investment attributed to the nonregulated activities.

305. In listing the advantages of Alternative 1, we noted that we had experience with this method, which was prescribed for protocol conversion and basic packet switching services offered by New Jersey Bell. In addition, this alternative could be implemented easily because no amendments to our accounting rules would be necessary. At the same time, we voiced our concern that the relationships between investment and expenses may be distorted because the system included investment in the regulated accounts, with related expenses recorded in separate books of account. We also noted that Alternative 1 may prove difficult to audit.

306. Alternative 2 proposed not to use separate accounting books for costs and revenues associated with services provided by the integrated telecommunications network. Under that proposal, a carrier would use operating accounts for all of its network services and nonoperating accounts for its non-network services. Thus, as proposed, non-network services would be treated the same way as they would be treated under Alternative 1. Network services, on the other hand, would be assigned and allocated between regulated and nonregulated operations, following procedures set out in the cost manual, and the carrier would regularly report regulated and nonregulated amounts to this Commission. While implementation of this alternative would require a rule change, the NPRM posited that Alternative 2 would facilitate monitoring and circumvent

the distortions caused by separate accounts.

307. For the reasons discussed below, we will adopt a modified version of Alternative 2, wherein all activities involving the use of common plant, whether network or non-network, will be accounted for in the regulated accounts rather than in a separate set of books. Under this accounting scheme all investments, revenues and expenses related to activities using common plant will be included in regulated accounts. Carriers will be required to keep detailed worksheets showing how these costs are assigned and allocated between regulated and nonregulated services. Separate accounting will still be used to record nonregulated activities that do not involve the use of common plant.

2. Comments

308. The comments filed on this issue included endorsements of both Alternatives 1 and 2, suggestions for modifying these alternatives, and arguments that we should adopt wholly different accounting schemes. Several parties urged adoption of Alternative 1, [FN474] generally arguing that bifurcating costs in operating and non-operating accounts is inherently more accurate and auditable than the Alternative 2 approach. In addition, ANPA, ATAER and DEC argue that our cost allocation scheme should mimic structural separations to the greatest extent possible. Tennessee proposes a modification to Alternative 1 that would credit Account 526 (Other Operating Revenues), rather than the common expense accounts, for common expenses and compensation for the use of common plant.

309. Of the parties opposing the adoption of Alternative 1, most contend that separating related costs in operating and nonoperating accounts would obfuscate cost relationships and would interfere with monitoring efforts. ICA argues that this effect becomes especially pronounced if regulated and nonregulated facilities are collocated in central offices. [FN475] Several parties argue that additional problems inhere in an accounting scheme that records investment in regulated accounts and revenues and expenses related to that investment in nonregulated accounts. They contend that the return on the portion of common plant associated with nonregulated activities cannot be calculated accurately unless all revenues and expenses are maintained in the regulated books with the corresponding common plant. They argue that the distortions caused by the mismatch between investment and related expenses will become increasingly pronounced as nonregulated activities proliferate. [FN476] AT & T further argues that the proposal that carriers keep nonregulated investment according to Part 31 accounts and subaccounts contravenes Commission precedent and would be so unduly burdensome to the carriers as to be inappropriate as a matter of law. [FN477]

310. Many parties favor Alternative 2, [FN478] generally arguing that this alternative would facilitate auditing. Ad Hoc, California, Michigan and New York argue that we should

require that subsidiary ledgers be maintained in addition to the Part 31 accounts, to provide additional data on nonregulated activity. New York further argues that these ledgers should reconcile allocations of regulated and nonregulated costs with the network service amounts that appear in the carriers financial statements. In addition, California argues that our Order should contain specific language stating that the scope of Alternative 2 is not limited to nonregulated activities, but should be redefined to encompass costs associated with all nontariffed activities.

311. Other commentors support a modified version of Alternative 2, in which costs associated with nonregulated, non-network activities would not be immediately recorded in Accounts 106 and 317, but would be included in operating accounts. [FN479] This position is generally supported with the assertions that a single accounting system would be less burdensome to the carriers, and that non-network costs can be completely segregated in subsidiary ledgers. SWB argues that placing non-network costs in nonregulated accounts would distort the relationship between nonregulated, non-network plant and related expenses, a distortion that we considered a major flaw in Alternative 1. SWB proposes that we establish service-specific subsidiary ledgers to segregate and track these costs. [FN480] NYNEX also argues that, if this proposal is adopted, Accounts 106 and 317 will no longer be necessary, and should be eliminated from the USOA. [FN481]

312. Several parties oppose Alternative 2, arguing that, because it places all investment in common plant in regulated accounts, the risk of failure of nonregulated services is placed entirely on the regulated ratepayers, who would bear the costs of stranded investment. [FN482] This effect allegedly is exacerbated by Alternative 2's failure to explicitly require that dedicated nonregulated assets collocated with network facilities be directly assigned to nonregulated ledgers. [FN483] AT & T argues that, because Alternative 2 would record revenues and expenses not related to common carrier service in the regulated accounts, nonregulated accounts will show understated net revenues and investment. [FN484] AT & T also argues against the modified Alternative 2 proposed by other parties. AT & T argues that Democratic Central Committee requires that separate books be maintained for costs associated with non-network activities. According to AT & T's interpretation of that case, intra-entity transfers of non-network support assets must either be made at market value (which purportedly would run contrary to generally accepted accounting principles, or GAAP) or the nonregulated activity must pay an imputed rent for the assets, as under Alternative 1. [FN485] The final argument against Alternative 2 is raised by DEC, which contends that integrating regulated and nonregulated services will result in diseconomies of scope that will be detrimental to ratepayers. DEC argues that separate accounting treatment is required to monitor regulated and nonregulated costs. [FN486]

313. In addition to the above comments on Alternatives 1 and 2, several parties argue that neither alternative is appropriate, and propose their own accounting schemes. AT & T, IBM and US Sprint advocate an accounting scheme that would divide common investment and related costs between regulated and nonregulated accounts. They argue that the NPRM's premise that

"the investment in a single item of common plant could not, consistent with good accounting principles, be split between operating and non-operating accounts ..." is fundamentally flawed. [FN487] AT & T argues that splitting a commonly-used asset between different accounts not only comports with GAAP, but is required by the Financial Accounting Standards Board (FASB). [FN488] In a related argument, Rochester and other parties argue that Alternative 2 would require that carriers record costs associated with nonregulated activities in Part 31 accounts, and that such a prescription would exceed this Commission's authority. [FN489]

314. US Sprint further argues that both Alternatives 1 and 2, by recording costs associated with nonregulated services in regulated accounts, will create a depreciation reserve deficiency that will ultimately increase rates for regulated service. [FN490] US Sprint argues that plant used to provide nonregulated service will be recorded in regulated accounts, and must necessarily reflect the asset lives and depreciation rates prescribed for regulated services. Sprint argues that the actual useful life of plant used in nonregulated services typically will be considerably less than that of plant used to provide regulated services. Sprint alleges that nonregulated plant will be retired well before it is depreciated in the regulated accounts, thus creating a substantial depreciation reserve deficiency that will be stranded on the regulated books, and borne by the regulated ratepayers. Sprint concludes that this depreciation reserve deficiency can only be avoided by recording the costs associated with the portions of common plant used to provide nonregulated service in nonregulated accounts.

315. Finally, US Sprint argues that failure to separate fully all costs related to regulated and nonregulated activities will burden the regulated ratepayers with any increases in the cost of debt experienced by carriers as a result of their increasing involvement in nonregulated ventures. [FN491] Sprint contends that, as carriers become increasingly involved in relatively high-risk competitive activities, their bond ratings will drop and their cost of debt will increase. Sprint then argues that, because both Alternatives 1 and 2 merely charge nonregulated services a rate of return for nonregulated investments held in regulated accounts, they ignore the cost-of-debt issue, and understate the actual costs of such investments to the regulated ratepayer.

316. Other parties also propose different accounting schemes. NYNEX and Arthur Andersen argue that carriers should be accorded the flexibility to use either integrated or separate book systems to account for common costs. [FN492] Alabama states that we should require carriers to maintain two sets of books, one fully segregating regulated and nonregulated costs, and one showing integrated accounts. [FN493] Arkansas argues that either alternative would require too much time and effort, and proposes that accounting systems be prepared for each study area through the Joint Board process. [FN494] The Joint Telcos argue that whatever accounting plan is chosen should only apply to Tier 1 companies. [FN495] Rochester proposes that small carriers be allowed to account for nonregulated services as incidental activities. [FN496] Contel argues that all nonregulated activities be treated as nonaffiliated customers, subject to transfer pricing rules. [FN497]

3. Discussion

317. We find substantial support in the record for the conclusion that Alternative 2 is preferable to Alternative 1, and we will adopt Alternative 2, with certain modifications. We disagree with the parties who argue that a system employing separate accounts for costs associated with regulated and nonregulated services is inherently more accurate than the system proposed in Alternative 2. In the NPRM, we explained the distortions that could result from a system that records all common investment in regulated accounts and a portion of the revenues and expenses related to that investment in nonregulated accounts. This view was widely endorsed by commenting parties, and was not refuted by opponents of Alternative 2.

318. We find unpersuasive the arguments that Alternative 1 is more auditable than Alternative 2. We believe that if investment and related expenses appear in regulated accounts, the relationships between these costs will be more easily discerned. In addition, we are adopting modifications to Alternative 2 that include requirements for detailed subaccounts or subsidiary record categories that will further enhance our monitoring and auditing capabilities. These modifications are discussed in detail below.

319. We also disagree with the argument that the cost accounting scheme adopted in this Order should mimic structural separation. We find that such an approach would limit carrier flexibility and would deny the carriers and the ratepayers the benefits that originally inspired our departure from structural separation. Finally, we will not adopt the Tennessee proposal to record credits for common expenses charged to nonregulated activities in Account 526 instead of the common expense accounts. We see no benefit in such a scheme, and find that it would interfere with the auditing function by unnecessarily aggregating costs in the Other Operating Revenues account. [FN498]

320. In adopting Alternative 2, we accept the arguments of the parties claiming that maintaining investment and related expenses in regulated accounts will facilitate monitoring and auditing by preserving the relationships between expenses and investment. We also agree that some modifications to Alternative 2 are necessary. We find merit in the argument that expenses and revenues associated with common investment [FN499] used for non-network applications should not be treated differently from other investment-related common costs. We believe that our concern that distortions may result from segregating investment from related expenses and revenues applies equally to common costs relating to network and non-network activities.

321. We note, however, that our decision to record non-network common costs in operating accounts will require that detailed worksheets be established to identify and track the allocation of these costs. After closing their books, carriers will treat the costs and revenues

associated with non-network services and those associated with network services alike, assigning and allocating them between regulated and nonregulated operations pursuant to the procedures established in their cost manuals. The portion of these costs associated with nonregulated activities will be deducted from the operating account balances prior to jurisdictional separations, [FN500] but will remain in the books of accounts for financial reporting purposes. As noted in the NPRM, specific reporting requirements will be established in a future proceeding. [FN501]

322. We believe that this requirement will provide us with sufficient data to identify and track all common costs, and we will not at this time adopt New York's proposal to require carriers to reconcile these reports with their financial statements. We note, however, that we may consider the merits of this proposal in the future. California's suggestion that the accounting scheme adopted in this section be applied to all nontariffed activities will not be adopted because it is inconsistent with the definitions of regulated and nonregulated activities we have adopted in this Order.

323. The modifications described above, and other aspects of the Docket 86-111 accounting scheme adopted in this Order, effectively answer many of the concerns raised by opponents of Alternative 2. The argument that recording all investment in regulated accounts will place the entire burden of investment risk on the regulated ratepayers has been specifically addressed by the allocation mechanism. The requirement that projections of use provide the basis for allocation of costs between regulated and nonregulated services also assures that our modified Alternative 2 will not understate nonregulated costs. The arguments that accounting separation is required for effective cost monitoring and that dedicated collocated plant will be misallocated under Alternative 2 have been addressed by our requirement that detailed worksheets be maintained and by our standards for accounting for dedicated costs. Since these recordkeeping requirements establish an auditable accounting trial, they also respond to DEC's argument that separate books of account are necessary to monitor costs that may arise from diseconomies of scope. [FN502]

324. In adopting the modified Alternative 2 approach, we find unconvincing the contentions that all common investment should be divided between regulated and nonregulated books of account. We disagree with AT & T's argument that Democratic Central Committee compels such a result. The finding in that case applies to the disposition of property removed from regulation, but does not address the allocation of costs related to property that is used for regulated activities. As such, Democratic Central Committee does not prevent us from requiring that costs associated with nonregulated activities be recorded in the regulated books. AT & T's claim that the Financial Accounting Standards Board statements of financial standards require that individual items of plant be separated between regulated and nonregulated books does not justify a different conclusion. Standards established by FASB for purposes of financial accounting frequently reflect concerns and accounting practices that are not relevant to cost accounting systems. The FASB standards are therefore not controlling in this instance.

325. We also find that the arguments challenging our authority to adopt the modified Alternative 2 are wholly without merit. In opposing both Alternatives 1 and 2, Rochester contends that each would "require exclusively nonregulated investments to be classified and recorded in accordance with Part 31 rules ..." and that such a requirement is an "unwarranted [intrusion] upon completely nonregulated matters and activities." [FN503] Our Section 220 powers are clearly broad enough to enable this Commission to regulate all accounts of a corporate entity that offers interstate telecommunications services. Moreover, it is necessary to record exclusively nonregulated investment in Part 31 or Part 32 accounts because the services that support such investment may not be similarly dedicated. The costs of these services frequently are allocated between regulated and nonregulated accounts in proportion to the total amounts of regulated and nonregulated investment they support. It is essential to this allocation process that the total amounts of regulated and nonregulated investment be identified in Part 31 or Part 32 accounts. Note also that these rules apply only to nonregulated activities conducted by operating telephone companies without establishing a separate corporate entity. Carriers can avoid these rules by establishing legal corporate entities for conducting nonregulated activities.

326. US Sprint's argument that adoption of Alternative 2 would result in burdening ratepayers with substantial depreciation reserves is similarly lacking in merit. First, Sprint describes the experience of Telenet Communications Corporation, whose packet-switching equipment has had an average useful life of five years, and posits that this experience is indicative of the asset lives that will be seen throughout the industry as carriers become increasingly involved in nonregulated activities. We must dismiss the analogy of Telenet's experience with that of the industry at large as unsupported and overly speculative. In fact, we have had considerable experience with the issue of the difference between equipment lives used for competitive services and for monopoly services. Beginning in 1981 we have prescribed lives and depreciation rates for circuit equipment associated with the highly competitive digital data services (DDS) separately from those for circuit equipment associated with largely monopoly services. [FN504] After six years of experience we have found that the DDS circuit lives are nearly as long as the standard circuit equipment. [FN505] As such, we cannot agree that a significant depreciation imbalance will emerge between regulated and nonregulated activities.

327. In addition, we note that if, arguendo, a disparity in the useful lives of assets used in regulated and nonregulated activities does occur, Part 32 of our Rules provides us with the flexibility necessary to ensure that depreciation reserve imbalances that burden the regulated services will not develop. These Part 32 Rules provide for classification of plant along narrowly-defined, technical/functional categories. If it can be demonstrated that the useful life prescription for any given category needs to be adjusted, we will be in a position to make the necessary changes.

328. Finally, we cannot accept US Sprint's argument that increased levels of business risk associated with increased nonregulated activity undermine our selection of a modified Alternative 2. The accounting scheme we have adopted here has eliminated the feature whereby

nonregulated activities would compensate the regulated accounts for the use of non-network common investment. Because there is no need to calculate appropriate compensation using an imputed rate of return, the modified Alternative 2 effectively moots Sprint's argument. In addition, we note that the effects of increased operating risk on carriers that become increasingly involved in competitive ventures are being addressed by this Commission in the context of its ongoing review of the rates of return prescribed for AT & T and the local exchange carriers. [FN506]

329. Among the other proposed alternative accounting schemes, we find none with sufficient merit to supersede our proposed Alternative 2. To allow carriers the flexibility to implement either alternative would perpetuate the distortions inherent in the separate books approach, and might lead to a divergence in accounting methods that would preclude effective auditing. Conversely, we believe that requiring carriers to maintain two sets of books would be duplicative and overly burdensome to the industry.

330. We cannot agree with suggestions that a Joint Board be used to determine the accounting treatment of common plant. Such an approach would prove tremendously time consuming, would overburden Commission resources, and could result in a widely disparate set of accounting methods that would be difficult to monitor. We will not limit the effect of the accounting scheme adopted here to Tier 1 companies. The accounting rules are applicable to all companies that are subject to the USOA. We also will not accept the proposal to treat the nonregulated activities of small telephone companies as incidental activities. For reasons previously discussed this Order takes a restrictive, rather than an expansive approach to incidental activities. Finally, we will not accept the suggestion that we treat all nonregulated activities as transactions with nonaffiliated customers. This approach would effectively reimpose structural separation, and would not promote the efficiencies sought by this Commission.

VII. ORDERING CLAUSES

331. The proposal contained herein has been analyzed with respect to the Paperwork Reduction Act of 1980 and found to impose a new or modified information collection requirement on the public. Implementation of any new or modified requirement will be subject to approval by the Office of Management and Budget as prescribed by the Act.

332. IT IS ORDERED, that pursuant to Sections 4(i), 4(j), 201-205, 215, 218 and 220 of the Communications Act of 1934, 47 U.S.C. 154(i), 154(j), 201- 205, 215, 218 and 220, the policies, rules and requirements set forth herein ARE ADOPTED, effective March 23, 1987.

FEDERAL COMMUNICATIONS COMMISSION

William J. Tricarico
Secretary

APPENDIX A

PARTIES FILING COMMENTS IN DOCKET 86-111

Able Communications (Able)
Ad Hoc Telecommunications Users Committee (AdHoc)
Alabama Public Service Commission (Alabama)
American Broadcasting Companies, Inc.; CBS, Inc.; and National Broadcasting Companies, Inc. (AC, CBS, NBC)
American Newspaper Publishers Association (ANPA)
American Telephone and Telegraph Company (AT & T)
Ameritech Operating Companies (Ameritech)
Anchorage Telephone Utility (Anchorage)
Arkansas Public Service Commission (Arkansas)
Arthur Andersen & Co. (Arthur Andersen)
Associated Telephone Answering Exchanges (ATAE)
Association of Data Processing Service Organizations (ADAPSO)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation (BellSouth)
Centel Corporation (Centel)
Cincinnati Bell Telephone Company (Cincinnati Bell)
Cincinnati Bell, Inc.
Compuserve, Incorporated (Compuserve)
Consumer Federation of America (CFA)
Contel Corporation (Contel)
Coopers & Lybrand
Department of Justice (DOJ)
Digital Equipment Corporation (DEC)
Florida Public Service Commission (Florida PSC)
GTE Telephone Companies (GTOCs)
Granite State Telephone, et. al. (Granite)
Idaho Public Utilities (Idaho)
Independent Data Communications Manufacturers Association, Inc. (IDCMA)
Information Industry Association (IIA)
International Business Machines (IBM)
International Communications Association (ICA)
Iowa State Commerce Commission (IOWA)
Joint Telco Parties

Kentucky Public Service Commission (Kentucky)
Kiesling and Associates (Kiesling)
MCI Telecommunications Corporation (MCI)
Michigan Public Service Commission Staff (Michigan)
Missouri Public Service Commission Staff (Missouri)
Motorola, Inc. (Motorola)
NYNEX Telephone Companies (NYNEX)
National Association of Regulatory Utility Commissioners (NARUC)
National Association of State Utility Consumer Advocates (NASUCA)
National Cable Television Association (NCTA)
National Telephone Cooperative Association (NTCA)
New York Department of Public Services (New York)
North American Telecommunications Association (NATA)
North-West Telephone Company (North-West)
Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO)
Pacific Telesis Group (PacTel)
Pennsylvania Public Utility Commission (Pennsylvania)
People of the State of California and the Public Utilities Commission of California (California)
Public Service Commission of West Virginia (West Virginia)
Public Service Commission of Wisconsin (Wisconsin)
Public Service Commission of the District of Columbia (DCPUC)
RCA Communications, Inc. (RCA)
Rochester Telephone Corporation (Rochester)
Southern New England Telephone Company (SNET)
Southwestern Bell Corporation (SWB)
Telephone and Data Systems, Inc. (TDS)
Telocator Network of America (Telocator)
Tennessee Public Service Commission (Tennessee)
US Sprint Communications Company (US Sprint)
US West, Inc. (US West)
United States Telephone Association (USTA)
United Telephone System, Inc. (United)
Western Conference
Western Union Telegraph Company (Western Union)
Wisconsin State Telephone Association (WSTA)

PARTIES FILING REPLY COMMENTS IN DOCKET 86-111

Ad Hoc Telecommunications Users Committee (Ad Hoc)

American Broadcasting Companies, Inc.; CBS, Inc.; and National Broadcasting Companies, Inc. (AC, CBS, NBC)
American Newspaper Publishers Association (ANPA)
American Telephone and Telegraph Company (AT & T)
Ameritech Operating Companies (Ameritech)
Anchorage Telephone Utility (Anchorage)
Associated Telephone Answering Exchanges (ATAE)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation (BellSouth)
Computer and Business Equipment Manufacturers Association (CBEMA)
Consumer Federation of America (CFA)
Contel Corporation (Contel)
Department of Justice (DOJ)
Digital Equipment Corporation (DEC)
GTE Telephone Companies (GTOCs)
Granite State Telephone, et. al. (Granite)
Independent Data Communications Manufacturers Association, Inc. (IDCMA)
International Business Machines (IBM)
International Communications Associations (ICA)
MCI Telecommunications Corporation (MCI)
Missouri Public Service Commission Staff (Missouri)
Motorola, Inc. (Motorola)
NYNEX Telephone Companies (NYNEX)
National Association of State Utility Consumer Advocates (NASUCA)
North American Telecommunications Association (NATA)
Office of the Consumer's Counsel, State of Ohio (Ohio OCC)
Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO)
Pacific Telesis Group (PacTel)
Public Service Commission of Wisconsin (Wisconsin)
Public Service Commission of the District of Columbia (DCPUC)
RCA Communications, Inc. (RCA)
Rochester Telephone Corporation (Rochester)
Southwestern Bell Corporation (SWB)
Tele-Communications Association Association (TCA)
Telocator Network of America (Telocator)
US Sprint Communications Company (US Sprint)
US West, Inc. (US West)
United States Telephone Association (USTA)
Vermont Public Service Board (Vermont)
Western Union Telegraph Company (Western Union)

Xerox Corporation (Xerox)

APPENDIX B

Part 31, "Uniform System of Accounts For Class A and Class B Telephone Companies," is amended as follows:

1. Section 31.01-10 is added to read:

s 31.01-10 Accounting Requirements--Nonregulated Activities

(a) This section describes the accounting treatment of activities classified for accounting purposes as "nonregulated." Preemptively deregulated activities and activities (other than incidental activities) never subject to regulation will be classified for accounting purposes as "nonregulated." Activities that qualify for incidental treatment under the policies of this Commission will be classified for accounting purposes as regulated activities. Activities that have been deregulated by a state will be classified for accounting purposes as regulated activities. Activities that have been deregulated at the interstate level, but not preemptively deregulated, will be classified for accounting purposes as regulated activities until such time as this Commission decides otherwise. The treatment of nonregulated activities shall differ depending on the extent of the common or joint use of assets and resources in the provision of both regulated and nonregulated products and services.

(b) When a nonregulated activity does not involve the joint or common use of assets and resources in the provision of both regulated and nonregulated products and services, carriers shall account for these activities on a separate set of books consistent with instructions set forth in Sections 31.106 and 31.317. Transfers of assets and sales of products or services between the regulated activity and a nonregulated activity for which a separate set pf books is maintained shall be accounted for in accord with the rules prescribed in Sections 31.01-11, Transactions with Affiliates. In the separate set of books, carriers may establish whatever detail they deem appropriate beyond what is necessary to provide this Commission with the information required in Section 31.106(b) and Section 31.317.

(c) When a nonregulated activity does involve the common or joint use of assets and resources in the provision of regulated and nonregulated products and services, carriers shall account for these activities within accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities. Carriers shall submit reports identifying regulated and nonregulated amounts in the manner and at the times prescribed by this Commission. Nonregulated revenue items not provided for elsewhere shall be recorded in a separate

subaccount of Account 316, Miscellaneous Income. Amounts assigned or allocated to regulated products or services shall be subject to Part 67 of this Chapter.

(d) To the extent that the instructions in this section are inconsistent with those prescribed elsewhere in this Part, the instructions in this section shall govern.

2. Section 31.01-11 is added to read:

s 31.01-11 Transactions With Affiliates

(a) Unless otherwise approved by the Chief, Common Carrier Bureau, transactions with affiliates involving asset transfers, or the provision of products or services, into or out of the regulated accounts shall be recorded by the carrier in its regulated accounts as provided in paragraphs (b) through (f) in this Section.

(b) Charges for assets purchased by or transferred to the regulated telephone activity of a carrier from affiliates shall be recorded in the operating accounts of the regulated activity at the invoice price if that price is determined by a prevailing price list held out to the general public in the normal course of business. If the assets received by the regulated activity are not marketed by the affiliated supplier to the general public under a prevailing price list, the charges recorded by the regulated activity for such assets shall be the lower of their cost to the originating activity of the affiliated group less all applicable valuation reserves, or their fair market value.

(c) Assets sold or transferred from the regulated accounts to affiliates shall be recorded as operating revenues, incidental revenues or asset retirements according to the nature of the transaction involved. If such sales are reflected in tariffs on file with a regulatory commission or in price lists held out to the general public, the associated revenues shall be recorded at the prices contained therein in the appropriate revenue accounts. If no tariff or prevailing price list is applicable, the proceeds from such sales shall be determined at the higher of cost less all applicable valuation reserves, or estimated fair market value of the asset.

(d) Services provided to an affiliate pursuant to a tariff, including a tariff filed with a state commission, shall be recorded in the appropriate revenue accounts at the tariffed rates. Services provided by an affiliate to the regulated activity, when the same services are provided by the affiliate to unaffiliated persons or entities, shall be recorded at the market rate. When a carrier provides substantially all of a service to, or receives substantially all of a service from, an affiliate, and such service is not also provided to unaffiliated persons or entities, the services shall be recorded at cost, which shall be determined in a manner that complies with the standards and procedures for the apportionment of joint and common costs between the regulated and nonregulated operations of the carrier entity.

(e) Income taxes shall be allocated among the regulated activities of the carrier, its nonregulated divisions, and members of an affiliated group. Under circumstances in which income taxes are determined on a consolidated basis by the carrier and other members of the affiliated group, the income tax expense to be recorded by the carrier shall be the same as would result if determined for the carrier separately for all time periods, except that the tax effect of carry-back and carry-forward operating losses, investment tax credits, or other tax credits generated by operations of the carrier shall be recorded by the carrier during the period in which applied in settlement of the taxes otherwise attributable to any member, or combination of members, of the affiliated group.

(f) The principles set forth in this section shall apply equally to corporations, proprietorships, partnerships and other forms of business organizations.

3. Section 31.106, "Nonregulated investments," is revised to read as follows:

s 31.106 Nonregulated investments.

(a) This account shall include the carrier's investment in nonregulated activities accounted for in a separate set of books as provided in Section 31- 01.10(b).

(b) This account shall be subdivided as follows:
106.1 Permanent investment
106.2 Receivable/payable
106.3 Current net income or loss.

4. Section 31.317, "Income from nonregulated activities," is revised to read as follows:

s 31.317 Income from nonregulated activities.

(a) This account shall be used by those companies who offer nonregulated activities that do not involve the joint or common use of assets or resources used in the provision of both regulated and nonregulated products and services, and which have not established a separate subsidiary for that purpose.

(b) All revenues and expenses (including taxes) incurred in these nonregulated activities shall be recorded on separate books of account for such operations. Only the net of the total revenues and total expenses shall be recorded in this account, with a contra debit or credit to account 106.3.

Part 64, "Miscellaneous Rules Relating to Common Carriers," is amended as follows:

1. Section 64.901 is added as follows:

s 64.901 Allocation of Costs

(a) Carriers required to separate their regulated costs from nonregulated costs shall use the attributable cost method of cost allocation for such purpose.

(b) In assigning or allocating costs to regulated and nonregulated activities, carriers shall follow the principles described herein.

(1) Tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service.

(2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

(3) Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:

(i) Whenever possible, common cost categories are to be allocated based upon direct analysis of the origin of the costs themselves.

(ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available.

(iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

(4) The allocation of central office equipment and outside plant investment cost between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment at the highest forecast relative nonregulated usage over the life of the investment.

APPENDIX C

Part 32, Uniform System of Accounts for Telecommunications Companies, is amended as follows:

1. The index to Part 32 is amended to reflect the new title of Section 32.23, and to add new Sections 32.27 and 32.7991 to read as follows:

PART 32--UNIFORM SYSTEM OF ACCOUNTS FOR TELECOMMUNICATIONS COMPANIES

* * * * *

Subpart B--General Instructions

* * * * *

32.23 Nonregulated activities.

* * * * *

32.27 Transactions with affiliates.

* * * * *

Subpart F--Instructions for Other Income Accounts

* * * * *

32.7991 Other nonregulated revenues.

* * * * *

2. Section 32.14 paragraphs (c), (d), (e), and (f) are revised to read as follows:

s 32.14 Regulated Accounts.

* * * * *

(c) In the application of the detailed accounting requirements contained in this Part, when a regulated activity involves the common or joint use of assets and resources in the provision of regulated and nonregulated products and services, companies shall account for these activities within the accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets used and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities. Companies shall submit reports identifying regulated and nonregulated amounts in the manner and at the times prescribed by this Commission. Nonregulated revenue items not provided for in regulated accounts shall be recorded in Account 7991, Other nonregulated revenues.

(d) Other income items which are incidental to the provision of regulated products and services shall be accounted for as regulated activities.

(e) All costs and revenues related to the offering of regulated products and services which result from arrangements for joint participation or apportionment between two or more telephone

companies (e.g., joint operating agreements, settlement agreements, cost-pooling agreements) shall be recorded within the detailed regulated accounts. Under joint operating agreements, the creditor will initially charge the entire expenses to the appropriate primary accounts. The proportion of such expenses borne by the debtor shall be credited by the creditor and charged by the debtor to the account initially charge. Any allowances for return on property used will be accounted for as provided in Account 5240, Rent Revenue.

(f) All items of nonregulated revenue, investment and expense that are not properly includible in the detailed, regulated accounts prescribed in Subparts A through F of this Part, as determined by paragraphs (a) through (e) of this section shall be accounted for and included in reports to this Commission as specified in s 32.23 of this subpart.

3. Section 32.23 is revised to read as follows:

s 32.23 Nonregulated activities.

(a) This section describes the accounting treatment of activities classified for accounting purposes as "nonregulated." Preemptively deregulated activities and activities (other than incidental activities) never subject to regulation will be classified for accounting purposes as "nonregulated." Activities that qualify for incidental treatment under the policies of this Commission will be classified for accounting purposes as regulated activities. Activities that have been deregulated by a state will be classified for accounting purposes as regulated activities. Activities that have been deregulated at the interstate level, but not preemptively deregulated, will be classified for accounting purposes as regulated activities until such time as this Commission decides otherwise. The treatment of nonregulated activities shall differ depending on the extent of the common or joint use of assets and resources in the provision of both regulated and nonregulated products and services.

(b) When a nonregulated activity does not involve the joint or common use of assets and resources in the provision of both regulated and nonregulated products and services, carriers shall account for these activities on a separate set of books consistent with instructions set forth in Sections 32.1406 and 32.7990. Transfers of assets, and sales of products and services between the regulated activity and a nonregulated activity for which a separate set of books is maintained, shall be accounted for in accordance with the rules presented in Section 32.27, Transactions with Affiliates. In the separate set of books, carriers may establish whatever detail they deem appropriate beyond what is necessary to provide this Commission with the information required in Section 32.1406 and Section 32.7990.

(c) When a nonregulated activity does involve the common or joint use of assets and resources in the provision of regulated and nonregulated products and services, carriers shall account for these activities within accounts prescribed in this system for telephone company

operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities. Carriers shall submit reports identifying regulated and nonregulated amounts in the manner and at the times prescribed by this Commission. Nonregulated revenue items not provided for elsewhere shall be recorded in a separate subaccount of Account 7991, Other Nonregulated revenues. Amounts assigned or allocated to regulated products or services shall be subject to Part 67 of this Chapter.

4. Section 32.27 is added to read as followed:

s 32.27 Transactions With Affiliates.

(a) Unless otherwise approved by the Chief, Common Carrier Bureau, transactions with affiliates involving asset transfers into or out of the regulated accounts shall be recorded by the carrier in its regulated accounts as provided in paragraphs (b) through (f) in this Section.

(b) Charges for assets purchased by or transferred to the regulated telephone activity of a carrier from affiliates shall be recorded in the operating accounts of the regulated activity at the invoice price if that price is determined by a prevailing price list held out to the general public in the normal course of business. If the assets received by the regulated activity are not marketed by the affiliated supplier to the general public under a prevailing price list, the charges recorded by the regulated activity for such assets shall be the lower of their cost to the originating activity of the affiliated group less all applicable valuation reserves, or their fair market value.

(c) Assets sold or transferred from the regulated accounts to affiliates shall be recorded as operating revenues, incidental revenues or asset retirements according to the nature of the transaction involved. If such sales are reflected in tariffs on file with a regulatory commission or in price lists held out to the general public, the associated revenues shall be recorded at the prices contained therein in the appropriate revenue accounts. If no tariff or prevailing price list is applicable, the proceeds from such sales shall be determined at the higher of cost less all applicable valuation reserves, or estimated fair market value of the asset.

(d) Services provided to an affiliate pursuant to a tariff, including a tariff filed with a state commission, shall be recorded in the appropriate revenue accounts at the tariffed rate. Services provided by an affiliate to the regulated activity, when the same services are also provided by the affiliate to unaffiliated persons or entities, shall be recorded at the market rate. When a carrier provides substantially all of a service to or receives substantially all of a service from an affiliate which are not also provided to unaffiliated persons or entities, the services shall be recorded at cost which shall be determined in a manner that complies with the standards and procedures for the apportionment of joint and common costs between the regulated and

nonregulated operations of the carrier entity.

(e) Income taxes shall be allocated among the regulated activities of the carrier, its nonregulated divisions, and members of an affiliated group. Under circumstances in which income taxes are determined on a consolidated basis by the carrier and other members of the affiliated group, the income tax expense to be recorded by the carrier shall be the same as would result if determined for the carrier separately for all time periods, except that the tax effect of carry-back and carry-forward operating losses, investment tax credits, or other tax credits generated by operations of the carrier shall be recorded by the carrier during the period in which applied in settlement of the taxes otherwise attributable to any member, or combination of members, of the affiliated group.

(f) The principles set forth in this section shall apply equally to corporations, proprietorships, partnerships and other forms of business organizations.

5. Section 32.102 is amended to read as follows:

s 32.102 Nonregulated investments.

Nonregulated investments shall include the investment in nonregulated activities that are conducted through the same legal entity as the telephone company operations, but do not involve the joint or common use of assets or resources in the provision of both regulated and nonregulated products and services. See s 32.14 and s 32.23.

6. Section 32.1220 paragraph (g) is revised to read as follows:

s 32.1220 Material and supplies.

* * * * *

(g) This account shall not include material and supplies which are related to a nonregulated activity unless that activity involves joint or common use of assets and resources in the provision of regulated and nonregulated products and services.

7. Section 32.1406 is revised to read as follows:

s 32.1406 Nonregulated investments.

(a) This account shall include the carrier's investment in nonregulated activities accounted for in a separate set of books as provided in Section 32.27(b).

(b) This account shall be subdivided as follows:

1406.1 Permanent investment
1406.2 Receivable/payable
1406.3 Current net income or loss.

8. Section 32.2311 paragraph (h) is revised to read as follows:

s 32.2311 Station apparatus.

* * * * *

(h) Embedded CPE is that equipment or inventory which was tariffed or otherwise subject to the jurisdictional separations process as of January 1, 1983. This account shall be used only by companies that have been permitted to offer tariffed CPE beyond December 31, 1987. CPE inventory includes the equipment in field stock and refurbished equipment held by the carrier on January 1, 1983.

9. Section 32.2321 paragraph (b) is revised to read as follows:

s 32.2321 Customer premises wiring.

* * * * *

(b) Embedded Customer Premises Wiring is that investment in customer premises wiring equipment or inventory which was capitalized prior to October 1, 1984.

10. Section 32.2341 paragraph (g) is revised to reads as follows:

s 32.2341 Large private branch exchanges.

* * * * *

(g) Embedded CPE is that equipment or inventory which is tariffed or otherwise subject to the jurisdictional separations process as of January 1, 1983. This account shall be used only by companies that have been permitted to offer tariffed CPE beyond December 31, 1987. CPE inventory includes the equipment in field stock and refurbished equipment held by the carrier on January 1, 1983. (Inventory of Large Private Branch Exchanges equipment is included in Account 1220, Material and Supplies.)

11. Section 32.6999 paragraph (b) is amended to add Account 32.7991 as follows:

s 32.6999 General.

* * * * *

(b) Other Income Accounts Listing.

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

12. Section 32.7990 is revised to read as follows:

s 32.7990 Nonregulated net income.

(a) This account shall be used by those companies who offer nonregulated activities that do not involve the joint or common use of assets or resources used in the provision of both regulated and nonregulated products and services, and which have not established a separate subsidiary for that purpose.

(b) All revenues and expenses (including taxes) incurred in these nonregulated activities shall be recorded on separate books of account for such operations. Only the net of the total revenues and total expanses shall be recorded in this account, with a contra debit or credit to account 1406.3.

13. Section 32.7991 is added to read as follows:

s 32.7991 Other nonregulated revenues.

(a) This account shall include revenues derived from a nonregulated activity involving the common or joint use of assets and resources in the provision of regulated and nonregulated products and services, which are not provided for elsewhere in this system of accounts.

(b) Separate subaccounts shall be maintained for each nonregulated revenue item recorded in this account.

FN1 Separation of the costs of regulated telephone service from costs of nonregulated activities, 104 FCC2d 59 (1986), hereinafter "Joint Cost NPRM" or "NPRM." A summary of the NPRM appears at 51 Fed.Reg. 16178 (May 1, 1986). Comments were due on June 30, 1986, with reply comments due July 30, 1986. Late-filed pleadings, and motions for acceptance thereof, were filed by Contel Corporation, the Tennessee Public Service Commission, US Sprint Communications Company and the Vermont Public Service Board. A motion to accept supplementary reply comments was filed August 29, 1986, by the Ameritech Operating Companies. These motions were unopposed and we grant them in the interest of obtaining a complete record upon which to base our decisions in this proceeding. Lists of all parties filing comments and replies appear as Appendix A to this Order. For many parties, a short name is given in parentheses. Throughout this Order we shall use these short names in citing to the comments and reply comments.

FN2 47 U.S.C. Sec. 201(b). For purposes of this Report and Order, the terms "interstate service" and "interstate jurisdiction" include "foreign" or international telecommunications services between points in the United States and foreign points and this Commission's jurisdiction to regulate the provision of such international services.

FN3 47 C.F.R. pts. 31, 33.

FN4 See Revision of the Uniform System of Accounts for Class A and Class B Telephone Companies, (CC Docket No. 78-196), Notice of Proposed Rulemaking, 43 Fed.Reg. 33560 (July 31, 1978).

FN5 Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies, 51 Fed.Reg. 43498 (December 2, 1986).

FN6 Automated Reporting Requirements for certain Class A and Tier I Telephone Companies, (CC Docket 86-182), Notice of Proposed Rulemaking, FCC 86-227 (released May 7, 1986).

FN7 47 C.F.R. Pt. 67.

FN8 47 USCA Sec. 410(c).

FN9 The term "assign" or "directly assign" is usually used when a particular item, account, category, cost pool, etc., belongs to only one jurisdiction or service, and the term "allocate" is usually used when it must be divided between two or more jurisdictions or services. The term "apportion" usually encompasses assignment and allocation. Note that our customary usage differs somewhat from that of the Cost Allocations Standards Board (CASB) which defined "allocate" as follows: "to assign an item of cost, or groups of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from indirect cost pools." 4 CFR Sec. 400.1 (1984).

FN10 Amendment of Part 67 of the Commission's Rules and Establishment of a Federal-State Joint Board, (CC Docket No. 86-297), FCC 86J-4 (released July 25, 1986).

FN11 See generally, Joint Cost NPRM, 104 FCC2d at 65-67.

FN12 AT & T Long Lines Department, Revisions of Tariff FCC No. 260, Private Line Services, Series 5000 (TELPAK), Docket No. 18128, 61 FCC2d 587 (1976), recon. 64 FCC2d 971 (1977), further recon. 67 FCC2d 1441 (1978), aff'd sub nom. Aeronautical Radio, Inc., v. FCC, 642 F.2d 1221 (D.C.Cir.1980).

FN13 Id. at 638. At the time of our 1976 decision we thought that private line services would be subject to competition but that MTS and WATS would remain sole source services. We believed we could foreclose cross-subsidization of the private line services by equitably distributing overall costs among all services, while at the same time requiring that all services earn the same rate of return.

FN14 Seven fully distributed costing methodologies were placed in the record of Docket 18128. Method I was similar to the method used in the Separations Manual. Method 7 was the historical

cost-causation approach.

FN15 AT & T, Manual and Procedures for Allocation of Costs, 84 FCC2d 667 (1981), aff'd sub nom. MCI Telecommunications Corp. v. FCC., 675 F.2d 408 (D.C.Cir.1982). The original ICAM categories were MTS, WATS, Private Line, and ENFIA. Since divestiture, of course, AT & T no longer provides exchange access.

FN16 Private Line Rate Structure and Volume Discount, 97 FCC2d 923 (1984).

FN17 Guidelines for Dominant Carriers' MTS Rates and Rate Structure Plans, FCC 85-540 (released October 17, 1985).

FN18 The USOA accounts which feed into the separations process, and which thus form the basis for ratebase regulation, have traditionally been described as "above the line" or "ratemaking" accounts, while accounts which are not separated between the jurisdictions are described as being "below the line." An "above the line" cost is presumptively allowable for ratemaking purposes and a "below the line" cost is presumptively excluded.

FN19 See AT & T, Charges for Interstate Telephone Service, Docket No. 19129, Phase II, 64 FCC2d 1, (1977) (AT & T Interstate Charge Order).

FN20 47 U.S.C.A. Sec. 215. Sec. 215(a) directs this Commission to examine carrier transactions, and grants this Commission authority to inspect and examine the accounts, records, and memoranda of parties to such transactions. Section 215 was adopted by Congress in lieu of the type of pervasive, mandatory regulation of affiliate relations that it imposed on gas and electric utilities in the Public Utilities Holding Company Act of 1934. Courts have given a broad interpretation to the scope of our authority under Section 215. See, e.g., North American Telecomunications Ass'n. v. FCC, 772 F.2d 1282, 1293 (1985); Phonetele Inc. v. AT & T, 435 F.Supp. 207 (1977), reversed on other grounds, 664 F.2d 216 (1981).

FN21 See AT & T Interstate Charge Order, 64 FCC2d at 5-45.

FN22 47 U.S.C.A Sec. 219. Sec 219(a) authorizes this Commission to require annual reports from all carriers subject to the Act and from "persons directly or indirectly controlling or controlled by, or under direct or indirect common control with any such carriers...." See also 47 U.S.C.A. Sec. 218, which authorizes this Commission to inquire into the management of the business of subject carriers and to obtain from carriers and carrier affiliates "full and complete information necessary to enable the Commission to perform the duties and carry out the objects for which it was created."

FN23 47 C.F.R. Sec. 43.21(c).

FN24 Regulatory and Policy Problems Presented by the Interdependence of Computer and Communications Services and Facilities, Tentative Decision, 28 FCC2d 291 (1970); Final Decision and Order, 28 FCC2d 267 (1971), aff'd sub nom. GTE Service Corp. v. FCC, 474 F.2d 724 (2d Cir.1973); decision on remand, 40 FCC2d 293 (1973).

FN25 We did not apply the Computer I scheme to the Bell system because we assumed that the terms of the 1956 Consent Decree in United States v. Western Electric, 13 RR 2143, 1956 Trade Cas. 71, 134 (D.N.J.1956), barred Bell companies from offering nonregulated data processing services.

FN26 GTE Service Corporation v. FCC, 474 F.2d 724, 732-37 (1973).

FN27 Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), 77 FCC2d 384, modified on recon., 84 FCC2d 50 (1980), further modified on recon. 88 FCC2d 512 (1981), aff'd sub nom. Computer and Communications Indus. Ass'n v. FCC, 693 F.2d 198 (D.C.Cir.1982), cert. denied 461 U.S. 938 (1983), aff'd on second further recon., FCC 84-800 (released May 4, 1984).

FN28 Section 64.702(a) of our rules defines enhanced services as follows:

[T]he term "enhanced service" shall refer to services offered over common carrier transmission facilities which employ computer processing applications that act on the format, content, code, protocol or similar aspects the subscriber's transmitted information; provide to the subscriber additional, different or restructured information; or involve subscriber interaction with stored information.

FN29 77 FCC2d 384, 476.

FN30 47 C.F.R. Sec. 64.702.

FN31 In the Computer II Final Decision, we imposed structural separation requirements on AT&T and GTE, 77 FCC2d at 466-75, but in the Reconsideration Order we concluded that the costs of applying those requirements to GTE exceeded the benefits, and therefore limited those requirements to AT & T, 84 FCC2d at 72-73.

FN32 77 FCC2d 384, 476.

FN33 Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Equipment by The Bell Operating Companies, 95 FCC2d 1117, aff'd sub nom. Illinois Bell Telephone v. FCC, 740 F.2d 465 (7th Cir.) aff'd on recon., FCC 84-252, 49 Fed.Reg. 26056 (1984), aff'd sub nom. North American Telecommunications Association v. FCC, 772 F.2d 1282 (7th Cir.1985).

FN34 Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), Fifth Report and Order, FCC 84-547, 49 Fed.Reg. 46378 (Nov. 26, 1984).

FN35 These rules were not limited to enhanced services and CPE.

FN36 We also deferred specifying the accounting mechanism for recording the apportionment of common plant betwen regulated and nonregulated activities.

FN37 The Computer II rules did not require maximum separation between carrier entities and all affiliated entities. Therefore, it was sometimes necessary to regulate transactions between non-carrier affiliates that were subject to maximum separation requirements and non-carrier affiliates that were not subject to such requirements.

FN38 American Telephone & Telegraph Co., Report on Services to be Shared between Fully Separated Subsidiary and Affiliated Companies and Associated Costing Methodology, 90 FCC2d 184 (1982); American Telephone & Telegraph Co., Report on Services to be Shared between Fully Separated Subidiary and Affiliated Companies and Associated Costing Methodology, 92 FCC2d 676 (1982); License Contract Agreements and Other Intra System Arrangements of the Major Telephone Systems, FCC 83-601 (released January 16, 1984); Letter from Chief, Common Carrier Bureau, to D.J. Culkin, AT & T (December 31, 1984); AT & T Information Systems, Inc., Petition for Waivers in Connections with AT & T Line of Business Reorganization, Mimeo No. 3925 (released April 18, 1985).

FN39 See, e.g., Petitions for Waiver of Section 64.702 of the Commission's Rules (Computer II), 100 FCC2d 1057, 1102 (1985); New Jersey Bell Telephone Company, Mimeo No. 0426 (released October 24, 1985); New Jersey Bell Telephone Company, Mimeo No 1426 (released December 13, 1985); application for review pending; Petitions for Waiver of Section 64.702 of the Commission's Rules and Regulations to Enable Certain Bell Operating Companies to Offer Digital NCTE Without Structual Separation, Mimeo No. 6893, para. 20, (released Sept. 11, 1985).

FN40 84 FCC2d 50, 79.

FN41 77 FCC2d 384, 483.

FN42 Democratic Central Committee v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C.Cir.1973).

FN43 Id. at 806, 807; see Implementation Proceeding, Order, 95 FCC2d 1276, 1309, 1316 (1983).

FN44 Implementation Proceeding, Notice of Inquiry, 89 FCC2d 694, 698 (1982).

FN45 Implementation Proceeding, Notice of Proposed Rulemaking, 94 FCC2d 76, 91 (1983).

FN46 Id. at 104-105.

FN47 Amendment of Sections 64.702 of the Commission Rules and Regulations. (Third Computer Inquiry), (CC Docket 85-229), Notice of Proposed Rulemaking, 50 Fed.Reg. 33581 (Aug. 20, 1985).

FN48 Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), Report and Order, Phase I, 104 FCC2d 958 (1986) (Phase I Order).

FN49 Id. paras. 223-265; see also Supplemental Notice of Proposed Rulemaking, Phase II, FCC 86-253 (released June 16, 1986).

FN50 Phase I Order, 104 FCC2d at 1059-68.

FN51 Furnishing of Customer Premises Equipment and Enhanced Services by American Telephone and Telegraph Company, 102 FCC2d 655 (1985).

FN52 Furnishing of Customer Premises Equipment by the Bell Operating Companies and the Independent Telephone Companies, CC Docket 86-79, FCC 86-529 (released January 12, 1987).

FN53 The other safeguards were in the areas of disclosure of network information, access to customer proprietary information, nondiscriminatory access to network services, and provision to independent CPE vendors of meaningful opportunities to market network services and CPE jointly.

FN54 104 FCC2d at 61.

FN55 Id.

FN56 SWB Comments at 2-3.

FN57 See, e.g., Contel Comments at 7-8.

FN58 Alabama Comments at 4.

FN59 ATAEC Comments at 2; Compuserve Comments at 6-7; IDCMA Reply at 6.

FN60 CBEMA Reply at 1-3.

FN61 Compuserve Comments at 6.

FN62 Motorola Comments at 1.

FN63 CFA Comments at 5.

FN64 See generally NASUCA Comments at 5-11; accord, TCA Reply at 8-9.

FN65 E.g. NASUCA Comments at 53, 55; MCI Reply at 58-60. A number of parties submitted, quoted from, or referenced Chapter 14 of a document prepared by the Public Staff Division of the California Public Utilities Commission, "A Report on Pacific Bell's Affiliated/Subsidiary Companies" (June 3, 1986). This report is part of the Public Staff's direct testimony in a pending rate case; Chapter 14 recommends a 5 percent royalty on gross income of Pacific Bell affiliates on the grounds that the affiliates should pay for the benefits they derive from their affiliation with Pacific Bell. At the request of Bureau staff, Pacific Bell submitted to the record of the instant rulemaking the direct testimony it submitted in the rate case in response to the Report. Pacific Bell moved that we accept this submission as a supplemental comment. Their motion was opposed by the Ohio Consumers Counsel, on the grounds that it would be unfair for us to accept late submissions when we had previously refused to extend the due date for reply comments. The motion was also opposed by the California Public Utilities Commission, which argued that, were we to accept this submission, we would in effect be litigating state rate case issues. California also stated that, if we were to accept this submission, we would also be obliged to accept all matter which had been or would be offered in response to Pacific's testimony. California submitted a copy of the entire Report and stated that additional materials would be submitted in the event that we granted Pacific Bell's motion. We will consider the materials submitted by Pacific Bell and by the California Commission to be part of the record of this proceeding.

FN66 Phase I Order, 104 FCC2d, at 1001-02.

FN67 See. para 109, below.

FN68 See, e.g., Authorized Rates of Return for the Interstate Services of AT & T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, FCC 85- 458, 50 Fed.Reg. 33786 (August 21, 1985), para. 22.

FN69 104 FCC2d at 82, 93-94. Under Part 31, Class A and Class B include all telephone companies with greater than $100,000 in annual operating revenues. Under Part 32, which is scheduled become effective January 1, 1988, Class A companies will be all those having annual

revenues from regulated telecommunications operations of $100 million or more.

FN70 Tier I Companies are LECs that earn more than $100 million in total company regulated annual revenues. Public Notice, Monitoring Plan, Mimeo No. 2133 (released January 25, 1985) at para 7.

FN71 104 FCC2d at 109.

FN72 E.g., OPASTCO Comments at 2.

FN73 Kiesling Comments at 1.

FN74 Anchorage Telephone Comments at 5, WSTA Comments at 6-8.

FN75 TDS notes that we have proposed $50 million revenues as the point at which certain automated reporting requirements would be applied to telephone companies; see Automated Reporting Requirements for certain Class A and Tier 1 Telephone Companies (Parts 31, 43, 67, and 69 of the FCC's Rules), Notice of Proposed Rulemaking, FCC 86-227, para. 23 (released May 7, 1986).

FN76 Pennsylvania Comments at 3.

FN77 US West Reply at 13-14; Joint Telco Parties Comment at 4.

FN78 NTCA Comments at 2-5; Rochester Comments at 16; Western Conference at 1; USTA Reply at 8-9. 50,000 lines is used in Sec. 67.631 of our Rules in connection with the expense adjustment whereby assistance is channeled to companies with high average loop costs. See also Third Computer Inquiry, Phase II, Supplemental Notice, para. 66 (seeking comment on a 50,000 line distinction in connection with applying Computer III nonstructural safeguards).

FN79 Granite Comments at 2-7; OPASTCO Comments at 2-7.

FN80 Able Comments at 1-4; Telocator Comments at 6-9. Able and Telocator submit transcripts from a state rate case of testimony showing that a small rural telephone company was allocating costs to its competitive mobile services by working from projected revenues to see how much cost the services could absorb. Able and Telocator offers this example as evidence of the need to apply cost allocation rules to small telephone companies; Granite, in reply comments, counters that the transcript actually proves that state rate regulation is adequate to identify and remedy misallocations of costs by small companies, Granite Reply at 19.

FN81 47 C.F.R. Sec. 31.01-3(x).

FN82 47 C.F.R. Sec. 31.01-3(cc).

FN83 Procedures for Implementing the Detariffing of Customer Premises Equipment and Enhanced Services (Second Computer Inquiry), Fifth Report and Order, FCC 84-547, 49 Fed.Reg. 46387 (Nov. 16, 1984), recon. denied, FCC 85-518 (released Sept. 27, 1985).

FN84 See NPRM, 104 FCC2d at 98.

FN85 See 47 C.F.R. Sec. 31.106; Fifth Report and Order, 49 Fed.Reg. 46387 at para. 28. See also NPRM, 104 FCC2d at 97-98.

FN86 See 47 C.F.R. Sec. 31.317; Fifth Report and Order, 49 Fed.Reg. 46387 at para. 28. See also NPRM, 104 FCC2d at 97-98.

FN87 NPRM, 104 FCC2d at 99-101.

FN88 Id. at 99.

FN89 47 C.F.R. Sec. 31.5-50(a).

FN90 NPRM, 104 FCC2d at 99-100.

FN91 Id. at 102.

FN92 Id.

FN93 Id. at 103.

FN94 Id. at 104.

FN95 Id.

FN96 Id. at 102 & n. 102. We had intended to propose a 0.5 percent standard. A typographical error caused the proposal to appear as .05 percent The error apparently did not prejudice the parties in developing their comments: those enthusiastic about .05 percent generally favored nonregulated accounting treatment for all incidental activities, while those finding that standard too restrictive generally favored limits of 1.0 percent or higher.

FN97 Id. at 102.

FN98 E.g., AT & T Comments at 41-42; Michigan Comments at 12; US West Comments at

62.

FN99 E.g., Arkansas Comments at 10-11; Missouri Comments at 19.

FN100 Arkansas Comments at 8-9.

FN101 E.g., AT & T Comments at 47-48; BellSouth at 32; Southwestern Bell Comments at 40.

FN102 E.g., AT & T Comments at 47-48; Southwestern Bell Comments at 40.

FN103 See, e.g., ADAPSO Comments at 21-23; Ameritech Comments at 35; SNET Comments at 23; UTSA Comments at 15-16. But see Bell Atlantic Comments at 14- 15 (company is willing to use above-the-line accounting for its nonregulated services).

FN104 US West Comments at 62.

FN105 PacTel Comments at 37-38. Accord Southwestern Bell Comments at 38-39.

FN106 PacTel Comments at 37-38.

FN107 E.g., Arkansas Comments at 26; Michigan Comments at 35.

FN108 E.g., BellSouth Comments at 31; MCI Comments at 7-8.

FN109 E.g., BellSouth Comments at 31; MCI Comments at 7-8; AT & T Reply at 31; NYNEX Reply at 34.

FN110 BellSouth Comments at 31.

FN111 MCI Comments at 8. See also NYNEX Reply at 34.

FN112 AT & T Comments at 46-48; AT & T Reply at 31.

FN113 AT & T Comments at 48-50.

FN114 ADAPSO Comments at 22.

FN115 US West Comments at 62, 64.

FN116 PacTel Comments at 37-38.

FN117 Rochester Comments at 16.

FN118 Ameritech Comments at 35.

FN119 Id. at 39.

FN120 Id. at 39.

FN121 Id.

FN122 Id. at 39-40.

FN123 Id. at 40.

FN124 Arkansas Comments at 10. See also Missouri Comments at 19.

FN125 Pennsylvania Comments at 2.

FN126 Idaho Comments at 6-7.

FN127 Florida PSC Comments at 20-21.

FN128 US Sprint Comments at 44-45.

FN129 Id. at 45.

FN130 Id. at 45.

FN131 Id.

FN132 NATA Reply at 26.

FN133 Id. at 26.

FN134 Id. at 27.

FN135 E.g., BellSouth Comments at 28-29; GTOCs Comments at 32-33; NYNEX Comments AT 35; Southwestern Bell Comments at 35-38.

FN136 E.g., (Rochester Comments at 35-36 (5.0 percent cap); Southwestern Bell Comments at 36 (3.0 percent cap).

FN137 E.g., GTOCs Comments at 32-33; US West Comments at 58-60.

FN138 USTA Comments at 29.

FN139 E.g., Ameritech Comments at 25; GTOCs Comments at 32-33; NYNEX Comments at 35; PacTel Comments at 36-37; SNET Comments at 22-23.

FN140 PacTel Comments at 26-27; accord NYNEX Comments at 35; GTOCs Comments at 32-33.

FN141 GTOCs Comments at 33.

FN142 SNET Comments at 22-23.

FN143 E.g., ANPA Reply at 6-7; DEC Reply at 7-8; IDCMA Reply at 40-41; Xerox Reply at 15-16.

FN144 E.g., ANPA Reply at 6-7; DEC Reply at 7-8; IDCMA Reply at 40-41; Xerox Reply at 15-16.

FN145 E.g., ADAPSO Comments at 34; AT & T Reply at 33; NATA Comments at 47.

FN146 NATA Comments at 47-48.

FN147 NPRM, 104 FCC2d at 97-100.

FN148 This Commission has forborne and streamlined the regulation of certain services which have not been determined to be noncommon carrier communication services. Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Therefor, Notice of Inquiry and Proposed Rulemaking, CC Docket No. 79-252, 77 FCC2d 308 (1979); First Report and Order, 85 FCC2d 1 (1980); Further Notice of Proposed Rulemaking, 84 FCC2d 445 (1981); Second Report and Order, 91 FCC2d 59 (1982), recon. denied, 93 FCC2d 54 (1983); Second Further Notice of Proposed Rulemaking, 47 Fed.Reg. 17308 (1982); Third Report and Order, 48 Fed.Reg. 46791 (1983); Third Further Notice of Proposed Rulemaking, 47 Fed.Reg. 28292 (1983); Fourth Report and Order, 95 FCC2d 554 (1983); Fourth Further Notice of Proposed Rulemaking, 49 Fed.Reg. 11856 (1984); Fifth Report and Order, 98 FCC2d 1191 (1984); Sixth Report and Order, 99 FCC2d 1020 (1985), rev'd and remanded on other grounds sub nom. MCI Telecommunications Corp. v. FCC, 765 F.2d 1186 (D.C.Cir.1985).

FN149 Activities such as Yellow Pages publication and real estate speculation are separate lines of business.

FN150 In the Inside Wiring Reconsideration Order at paras. 13-20, we affirmed our prior preemption of state regulation of inside wiring installation and maintenance, but deferred the effectiveness of our preemption decision for inside wiring maintenance services in the State of New York until January 1, 1990. Consistent with paragraph 21 of that Order and with our treatment of preemptively detariffed activities in this Order, subject carriers shall classify their inside wiring maintenance operations in that state, as well as all their other inside wiring operations, as nonregulated activities.

FN151 Report and Order, CC Docket No. 85-88, Detariffing of Billing and Collection Services, 102 FCC2d 1150 (1986), recon. denied, Memorandum Opinion and Order, FCC 86-472 (released Nov. 6, 1986).

FN152 While we preempted state regulation of LEC billing and collection for interstate services of interexchange carriers, Billing and Collection Detariffing Order, 102 FCC2d at 1177, we did not preempt regulation of billing and collection for intrastate services. Billing and Collection Reconsideration Order at para. 12.

FN153 47 U.S.C. Secs. 154(i), 201(b), 218-19, 220(a).

FN154 NPRM at para. 119.

FN155 47 U.S.C. Secs. 154(i), 201(b).

FN156 47 U.S.C. Secs. 154(i), 218-19.

FN157 47 U.S.C. Secs. 154(i), 220(a).

FN158 47 U.S.C. Sec. 152(b)(1).

FN159 E.g., Alabama Comments at 4-7; California Comments at 2; Michigan Comments at 37-39; Wisconsin Comments at 1-2. See also NYDPS Comments at 6.

FN160 106 S.Ct. 1890 (1986).

FN161 E.g., Alabama Comments at 4-5; Wisconsin Comments at 2.

FN162 Michigan Comments at 38.

FN163 Wisconsin Comments at 1.

FN164 NYDPS Comments at 2.

FN165 E.g., Alabama Comments at 5; Michigan Comments at 38-39; Missouri Reply at 1-2; NYDPS Comments at 7.

FN166 E.g., Wisconsin Reply at 3-4.

FN167 E.g., Michigan Comments at 39.

FN168 E.g., Missouri Reply Comments at 16-19; NYDPS Comments at 7.

FN169 E.g., NARUC Comments at 2; MCI Reply at 6; NATA Reply at 3-5; USTA Comments at 5.

FN170 NATA Reply at 3-5.

FN171 E.g., BellSouth Reply at 4; MCI Reply at 61; NARUC Comments at 3.

FN172 BellSouth Reply at 4, 16-17.

FN173 US Sprint Reply at 4.

FN174 Id. at 6. See also IDCMA Reply at 22-23.

FN175 NASUCA Reply at 4-7.

FN176 AT & T Reply at 30, quoting Louisiana Public Service Commission, 106 S.Ct. at 1902.

FN177 AT & T Reply at 30.

FN178 Southwestern Bell Comments at 15-16.

FN179 States must, of course, refrain from asserting any jurisdiction over activities that are identified as interstate regulated activities through the interaction of these rules and the Part 67 jurisdictional separations rules.

FN180 47 U.S.C. Sec. 410(c).

FN181 See Part III(C), supra. According nonregulated accounting treatment to an activity results in the exclusion of costs of that activity from the jurisdictional separations process.

FN182 See Inside Wiring Detariffing Order at para. 34.

FN183 Although we are continuing to require regulated accounting treatment for certain limited activities which are not common carrier communication products or services, Section 410(c) does not preclude that action.

FN184 47 U.S.C. Sec. 410(c).

FN185 47 C.F.R. part 67; See paras. 8, 9, supra.

FN186 47 C.F.R. part 69.

FN187 AT & T, Manual and Procedures for the Allocation of Costs, 94 FCC2d 1118 (1983).

FN188 See para. 12, supra.

FN189 W.J. Baumol, J.C. Panzar, and R.D. Willig, Contestable Markets and the Theory of Industry Structure at 353.

FN190 NPRM, paras. 62, 101.

FN191 For convenience we use the abbreviation "FDC" in this discussion. This term should be understood in this context to refer to the general concept of fully allocated costing and not to any particular FDC methodology, such as the FDC1 or FDC7 methods developed in Docket 18128.

FN192 F.J. Alessio, Economic Criteria for Separating Costs of Regulated and Nonregulated Lines of Business (dated June 6, 1986), BellSouth Comments, Appendix B. The title page states that this paper was prepared for BellSouth Services, but does not indicate whether it has been published elsewhere.

FN193 See generally Areeda & Turner, Predatory Pricing and Related Practices under Section 2 of the sherman Act, 88 Harv.L.Rev. 697 (1975)

FN194 See para. 12, above.

FN195 Ameritech Comments at 7-8. The Ameritech proposal might be described as a variation of FDC costing.

FN196 Bell Atlantic Reply at 7.

FN197 US West Reply at 2-6.

FN198 SWB Comments at 19-24. SWB characterizes its approach as "full absorption costing"

and states that it differs from traditional FDC in that it makes greater use of causal/beneficial relationships in allocating cost than is the case with traditional FDC.

FN199 PacTel Comments at 19-20.

FN200 BellSouth Comments at 23-24.

FN201 Centel Comments at 2-3.

FN202 GTOC Comments at 5-9.

FN203 Id. Appendix A.

FN204 SNET Comments at 7-9.

FN205 TDS Comments at 3.

FN206 AT & T Reply at 3, 8.

FN207 DOJ Comments at 27-28, DOJ Reply at 8-9.

FN208 RCA Reply at 10.

FN209 US Sprint Comments at 17-19.

FN210 US Sprint makes a related argument that fully allocated costing can only doom a nonregulated enterprise to failure if the costs so assigned are greater than the cost of obtaining the equivalent goods or services from a third party and the nonregulated enterprise is prohibited from going outside for the services. US Sprint Reply at 19.

FN211 DEC Reply at 5-6.

FN212 Missouri Comments at 12-13. Missouri endeavors to maximize the "contribution" that can be gained both from services that are subject to competition and from services (such as optional centrex features) that are not subject to competition. The contribution from competitive services is maximized by pricing close to incremental cost so as not to cause demand to fall and contribution levels to diminish. The noncompetitive services get marked up to create the biggest possible contribution (in effect, a subsidy running to basic service). Basic services are then priced residually to cover the remainder of the revenue requirement.

FN213 RCA comments at 8-9.

FN214 More precisely, avoidance of cross subsidy requires that all activities and all combinations of activities earn revenues at least as high as the incremental cost of that activity or that combination of activities. The significance of considering combinations of activities is that narrowly defined activities will generally have very low incremental costs. In the example at para. 95, a price for iron ore hauling that just covered the incremental cost of iron ore alone and a price for coal hauling that just covered the incremental cost of coal alone would still cause the combined activity of iron and coal hauling to be receiving a cross subsidy from other activities if the combined revenues for the activities did not cover the combined incremental costs of iron and coal hauling activities. See Baumol, Planzar, and Willig at 351-356.

FN215 Such a subsidy ought not be possible under perfect competition, but it could be possible if a nonregulated service were not subject to much competition. Under the approach that we are developing here, the carrier that earns large profits from a nonregulated activity will not be required to share such profits with users of regulated services. Some state commissions may take a different approach.

FN216 A cost function is said to exhibit economies of scale if an increase in production results in a less than proportional increase in cost. A cost function is said to exhibit economies of scope if the cost of producing multiple products is less than the sum of producing each of the products separately. For formal definitions, see Baumol, Panzar, and Willig at 67-73.

FN217 W.W. Sharkey, "Suggestion for a Game-theoretic Approach to Public Utility Pricing and Cost Allocation," 13 Bell Journal of Economics (1982) 57, 68 (Sharkey). Sharkey proves various propositions that provide conditions under which a set of subsidy-free prices exist. The propositions require that both the cost functions and the demand functions exhibit certain properties. A sample theorem is: "if all buyers have quasi-concave utility functions and the cost function is both quasi-convex and has decreasing ray average costs, then the core of the welfare game is nonempty." (Sharkey at 65) Although Sharkey provides proofs that subsidy-free prices exist under certain conditions, he does not provide a particular method for discovering what those prices are.

FN218 A market is said to be contestable if there are no barriers to entry or exit. A contestable market is subject to competition because of the ease of entry, though there may be no actual competitors in the market. The concept of a contestable market has been developed in the economics literature to analyze complex multiproduct markets. See E.E. Bailey, "Contestability and the Design of Regulatory and Antitrust Policy," 71 American Economic Review (1981) 178.

FN219 One method of computing economically efficient prices is known as Ramsey pricing in which overhead costs are allocated in inverse proportion to the elasticity of demand. See W.J. Baumol and D.F. Bradford, "Optimal Departures from Marginal Cost Pricing," 60 American Economic Review 1970) 265. The attributable cost method is simpler than Ramsey pricing

because it does not require the measurement of the elasticity of demand for the final products. If the scale elasticity is unity or if the demand elasticity of the various products is identical, then the attributable cost method will be equivalent to Ramsey pricing with independent demands. See R.R. Braeutigam, "An Analysis of Fully Distributed Cost Pricing in Regulated Industries," 11 Bell Journal of Economics 182 at 189. The Ramsey pricing method used as a standard of comparison in Braeutigam's analysis of cost methodologies is itself a simplification of the more general framework used in contestablility analysis.

FN220 The apportionment of costs between regulated and nonregulated activities will occur before rather than after the jurisdictional apportionment. Therefore, most nonregulated costs will not be affected by any distortions in the jurisdictional separations process.

FN221 To the extent that regulated businesses have higher overheads due to administrative costs that are required to satisfy regulatory requirements, these costs should be identified and appropriately apportioned. But overhead costs which exist simply because of lack of competitive pressure to minimize costs should neither be imposed upon the ratepayer nor shared with the nonregulated sector; such costs should be eliminated.

FN222 Some nonregulated activities that are closely related to the provision of telecommunications services may affect the provision of economical and efficient communications service. We do have a legitimate interest in the pricing of such activities, but have generally found that the goals of the Communications Act can best be served by refraining from imposing rate regulation upon such ancillary activities.

FN223 I.e., distance-weighted usage for interexchange transmission facilities, 47 C.F.R. Sec. 67.125.

FN224 I.e., the Big 4 wage factor, 47 C.F.R. Sec. 67.403.

FN225 We did not propose to prescribe a manual because we believed that the mix of nonregulated activities and the organizational structure would vary widely from carrier to carrier, and that a single manual could not adequately encompass all of the possible variations.

FN226 E.g., NATA Reply at 5. In its comments, NATA stated that this Commission should prescribe detailed direct assignment criteria for each USOA account and subaccount. NATA comments at 13.

FN227 SNET Comments at 7.

FN228 ANPA Reply at 8, DEC reply at 15-16.

FN229 DOJ Comments at 20-21; DEC Reply at 15-16; IDCMA Reply at 11-12.

FN230 AT & T Reply, Appendix B at 29.

FN231 See, e.g., Iowa Comments at 2-3; Florida Comments at 3; New York Comments at 4-5; Tennessee Comments at 1-2; TCA Reply at 4-5, ADAPSO at 7-8, ANPA at 4-5.

FN232 BellSouth Comments at 9.

FN233 Pacific Telesis Reply at 37-38.

FN234 See, e.g., MCI comments at 11-12. Their invocation of CASB as governing our proceeding is misplaced. CASB has many relevant ideas, but it is not authoritative. It was developed for a different purpose, and much of it is inapposite to a regulated company operating under a uniform system of accounts.

FN235 See NATA Comments at 16-17.

FN236 ANPA Comments at 9; ATAE Comments at 6.

FN237 E.g., NATA Comments at 17-20.

FN238 E.g., Ameritech Comments at 15-16; Bell Atlantic Reply at 10-11; NYNEX comments at 47-49; Centel Comments at 11; OPASTCO Comments at 8; Rochester Comments at 27.

FN239 E.g., Arkansas Comments at 12, 14, 22; Kentucky Comments at 3.

FN240 E.g., Idaho Comments at 4; Missouri Comments at 21-22.

FN241 Idaho Comments at 4.

FN242 Florida Comments at 12-14; accord, SWB Comments at 21.

FN243 AT & T Reply at 15-16. AT & T notes that the threshold should be refined based on experience to as low a level as will accommodate normal usage variations. AT & T also explains that it does not mean to suggest that a formal waiver process be required to reallocate plant; in its view, a waiver process would cause delay that could lead to needless duplication of plant to meet regulated demand. Id. at 16 note*.

FN244 Id. at 17; see also Ad Hoc Comments at 9.

FN245 DOJ Comments at 20-21.

FN246 Id. at 22.

FN247 DOJ Reply at 11.

FN248 IBM Comments at 11-21.

FN249 Id. at 20. IIA makes a proposal similar to IBM's, and urges this Commission to establish procedures for recordation of capital investment and procurement data, including records of the determination of the need for new investment, its purpose, the financial breakdown of alternative investment possibilities, and the details of the bidding and procurement process. IIA Comments at 7-8, 15-16.

FN250 SWB Reply at 3-7. See also AT & T Reply, Appendix B, at 17-18. (Statement by Peat, Marwick that management does not make capacity decisions on a service by service basis, and that artificial constraints on reallocation based on such analysis could lead to uneconomic use of resources.)

FN251 CBEMA Reply at 5-7.

FN252 Missouri Reply at 4.

FN253 ABC, NBC, CBS Reply at 6.

FN254 Idaho Comments at 2, Tennessee Comments at 2, WSTA Comments at 8, West Virginia Comments at 4.

FN255 AT & T Reply at 17-20, Appendix B at 14; Anchorage Comments at 17; NTCA Comments at 18-19 (arguing that small telephone companies should be allowed to use multiple allocators); Rochester Comments at 22 (arguing that multiple allocators might be appropriate for larger telephone companies).

FN256 IDCMA Reply at 19-20 (arguing that total company residual costs should be limited to two percent of company revenues), NASUCA Comments at 56-57 (proposing three objective criteria to evaluate the reasonableness of the total residual cost amounts).

FN257 AT & T Comments at 17-19, CincinnComments at 5-6, DCPUC Comments at 4, NTCA Comments at 18-19, Pac Tel Comments at 12, US West Comments at 37-38. See also ADAPSO Comments at 12.

FN258 NYNEX Comments at 44-45.

FN259 Florida Comments at 5, MCI Comments at 9-10.

FN260 ANPA Reply at 8, IDCMA Reply at 14-15, Xerox Reply at 7-8.

FN261 AT & T Comments at 19, Reply Appendix B at 13-14; North-West Comments at 2; NYNEX Comments at 45; PacTel Comments at 11-12; United Comments at 9-10; US Sprint Comments at 35-37, Reply at 27-28.

FN262 PacTel Comments at 12-13. PacTel also argues, however, that monthly variations will not be pronounced, and that annual compilations of data may provide an accurate and more inexpensive alternative.

FN263 Cincinnati Comments at 7, Contel Comments at 13, Michigan Comments at 16, Rochester Comments at 22.

FN264 Florida Comments at 5.

FN265 California Comments at 18.

FN266 Centel Comments at 12-13. Contra ADAPSO Comments at 12, Cincinnati Comments at 5-6, Michigan Comments at 14, United Comments at 10 (supporting the NPRM's proposal that revenues should not be included in the computations).

FN267 BellSouth Comments at 12-13.

FN268 Ameritech Comments at 16-17.

FN269 GTOCs Reply at 8-9.

FN270 SWB Comments at 13-14.

FN271 SNET Comments at 13-14.

FN272 US Sprint Comments at 37.

FN273 California Comments at 17-18.

FN274 Arkansas Comments at 19.

FN275 See paras 275-283, below.

FN276 DOJ Comments at 28-31. For further elaboration of the technical characteristics of the attributable cost method, see D. Sibley, The Theory of Public Utility Pricing (1986); R. Braeutigam, "An Analysis of Fully Distributed Cost Pricing in Regulated Industries," 11 Bell Journal of Economics 182 (1980); H.P., Young, "Producer Incentives in Cost Allocation," 53 Econometrica 757 (1985); S. Hamlin, W. Hamlin, and J. Tschirhart, "The Use of Core Theory in Evaluating Joint Cost Allocation Schemes," 52 Accounting Review (1977) 616; 1 A.E. Kahn, The Economics of Regulation, 150-158 (1970).

FN277 We note that the general allocator adopted in this Order will not apply to costs associated with common marketing ventures. As described in paras. 188-208, below, marketing costs involve unique concerns and generate a greater amount of legitimate residual costs than other types of costs generated by carriers. These unique concerns prompted us to require that residual marketing costs be allocated in proportion to the amount of directly assigned and attributed marketing costs. We may, at a later date, find that other groups of costs exhibit unique characteristics that merit similarly individualized treatment. If such a determination is made, we may seek to amend our accounting rules in a future proceeding.

FN278 NPRM, 104 FCC2d at 81-82.

FN279 Examples of Part 32 Accounts which are likely to be allocable on the basis of a direct analysis are the central office switching and transmission accounts (2211-2215 and 2231-2232), operator systems (2220), most of the information origination/termination accounts (2311-2351), most of cable and wire facilities accounts (2421-2431), the marketing expense accounts (6611-6613), and portions of accounts 6623 and 6722.

FN280 Although the record is insufficient to support a specific percentage goal, in various ex-parte presentations various carriers have stated that between 80 percent and 90 percent of all costs can be allocated on a cost causative basis. We believe this is a realistic target.

FN281 By maintenance expense we mean the Plant Specific Operations Expenses (Network Support Expense) accounts 6110-6441.

FN282 Although states will not be required to use the apportionment procedures we are adopting in this Report and Order, carrier manuals should be designed to apportion costs on a study area basis in order to enable the carriers to use the regulated category results for jurisdictional separations purposes.

FN283 There are a few cases in which the immediate demand determines the investment expenditure. A carrier may continue to add lines to a switch until the day it intends to retire it.

In this case the lines are being installed in response to very short term demands.

FN284 Grant of a waiver will be conditional on a showing that the regulated operation has need of additional capacity and that the regulated operation cannot obtain that additional capacity at a lower cost from any other source.

FN285 In positive time reporting, an employee's day is parcelled into increments of time, typically six minutes to one hour in length. The employee then accounts for all or most of the time worked during a given day by dividing the total amount of hours worked among the specific jobs or functions performed.

FN286 Under exception time reporting, an employee's time is assumed to be devoted entirely to one or more jobs or functions in which the employee is normally engaged. The employee actively reports only the time spent on activities that depart from the expected schedule.

FN287 104 FCC2d at 88-89.

FN288 ATU, United, TDS and the small telephone companies represented by NTCA predominantly use positive time reporting.

FN289 See Ameritech Comments at 20-22; ATU Reply at 6-7; BellSouth Comments, Appendix C, at 1-4; Cincinnati Bell Comments at 13-15; GTOCs Comments at 29; NTCA Comments at 17; NYNEX Comments at 51-55, Reply at 43-44; PacTel Comments at 21-22, Reply at 21-24; Rochester Comments at 26; SWB Comments at 20 and Appendix 3; TDS Comments at 7-8; United Comments at 10.

FN290 BellSouth Comments, Appendix C, at 1-4.

FN291 ANPA Reply at 8; DEC Reply at 15-16; Florida PSC Comments at 10-12; IDCMA Reply at 32; Kentucky PUC Comments at 4; MCI Comments at 19-20; Motorola Reply at 12; NASUCA Comments at 27-29; NATA Reply at 12; Telocator Comments at 9; Tennessee Comments at 2; US Sprint Comments at 27-30.

FN292 IBM Comments at 21-24, Reply at 13-15. See also Ad Hoc Reply at 11.

FN293 AT & T Reply at 22-23.

FN294 Two parties contend that, because time reporting is inherently subjective and manipulable, it should not be used as a basis for computing employee compensation. This action assertedly would remove incentives for incorrect reporting. ADAPSO Comments at 11-12, RCA Reply at 9. Because this concern is most visible in the context of sales commissions, this argument will

be addressed in our discussion of marketing costs, infra.

FN295 California Comments at 14-15, IDCMA Reply at 32-37.

FN296 IDCMA Reply at 32-37, incorporating by reference comments and ex parte communications filed in the Commission's proceeding in CC Docket No. 85-26. See also Florida PSC Comments at 10-12.

FN297 Arkansas Comments at 21, Michigan Comments at 24, West Virginia Comments at 2.

FN298 The American Telephone and Telegraph Co., 90 FCC2d 184, 198-99 (1982).

FN299 See also The National Association of Attorneys General, Committee on the Office of Attorney General, Time Reporting in Attorneys General's Offices 26- 27 (1978), which discusses the results of a survey of time reporting techniques used in attorneys general's offices throughout the country. The survey showed that systems using both 15-minute and one-hour increments were equally effective, and that these systems resulted in higher levels of billable hours than time reporting systems using different increments.

FN300 Furnishing of Customer Premises Equipment and Enhanced Services by American Tel. and Tel. Co., mimeo no. 5652 (adopted July 7, 1986) at para. 31.

FN301 Methods used to apportion non-productive time include positive time reporting to overhead accounts; start/stop time reporting, with unreported time allocated to overhead; and special studies to determine average periods of non-productive time. See generally Reed, Time Sheet Accounting, J. Systems Mgmt., Jan. 1979, at 32-35.

FN302 See generally id. at 35.

FN303 Granite Comments at 11, Idaho Comments at 5, Michigan Comments at 26-27, NYNEX Comments at 56.

FN304 BellSouth does not specify the cost elements that it proposes to delete from these accounts prior to the allocation process. From its description of Account 645 costs, however, it appears that BellSouth proposes to remove such overhead costs as office supplies, office furniture and equipment repair and postage.

FN305 BellSouth Comments at 9-15.

FN306 See also RCA Comments at 14, arguing that sales commissions should not be used as an allocation measure for joint marketing costs, because they are geared to sales prices, and may not

reflect sales effort accurately.

FN307 AT & T Comments at 28-30.

FN308 Anchorage Comments at 10, DCPUC Comments at 4-5, PacTel Comments at 27, SNET Comments at 18, Telocator Comments at 20, United Comments at 11. Telocator endorsed this plan as an alternative to its preferred proposal: to allocate all marketing costs that cannot be directly assigned to nonregulated services.

FN309 Sprint Comments at 32.

FN310 Rochester Comments at 28.

FN311 AT & T Comments at 29-30, DCPUC Comments at 4-5.

FN312 Ameritech Comments at 4-5.

FN313 Florida Comments at 14-15.

FN314 DEC Comments at 5, NASUCA Comments at 48, Telocator Comments at 19-20.

FN315 NASUCA Comments at 48.

FN316 Id. at 48-50.

FN317 NTCA Comments at 20.

FN318 This is essentially the same attribution approach that we have adopted for all costs, but we are devoting particular attention to marketing expenses because marketing activity is likely to produce a significant amount of unassignable cost.

FN319 See Account 645, which includes wages and expenses for guards and supervisors of coin-box collections.

FN320 Part 32 Order, FCC 86-221 at para. 153.

FN321 Specifically, the Part 32 Rules require that costs of initiating customer service orders be recorded in Account 6623. We find that the customer contact involved in establishing new residential and business accounts, and in adding new services to an extant phone account, is a necessary extension of the marketing function, and that these costs should be included in the pool of marketing costs addressed in this section. Similarly, Account 6623 includes the costs of

instructing customers in the use of products and services. To the extent that such service constitutes an inducement to purchase, or is offered as part of a pre-purchase demonstration, these costs should also be classified as marketing costs. Our Rules also require that Account 6722 record costs associated with performing public relations and non-product related corporate image advertising activities. To the extent that these activities are intended to foster public awareness of a carrier's name, reputation or activities, they should be classified as marketing costs.

FN322 AT & T Accounting Plan Order, mimeo no. 5652, at para. 31.

FN323 The depreciation reserve is a balance sheet account that records depreciation amounts as they accrue over time. National Association of Public Utility Commissioners, Public Utility Depreciation Practices 35-39 (1968) (Naruc Depreciation Text).

FN324 Granite Comments at 10, Opastco Comments at 9, United Comments at 12, US West Comments at 50, WSTA Comments at 10.

FN325 Ad Hoc Comments at 20, Anchorage Comments at 11-12, AT & T Comments at 33, Idaho Comments at 6, NASUCA Comments at 45, Sprint Comments at 34-35.

FN326 Arthur Andersen Comments at 13, California Comments at 15, DCPUC Comments at 5, Florida Comments at 16, Michigan Comments at 28, SNET Comments at 19.

FN327 BellSouth Comments, Appendix C, at 17.

FN328 See Ameritech Comments at 23.

FN329 SNET Comments at 19.

FN330 PacTel Comments at 29. SWB also endorses the use of vintage reserve reclassification ratios.

FN331 Depreciation reserve deficiencies occur when actual plant retirements occur sooner than the accounting system anticipates. These deficiencies can result from imperfections inherent in a depreciation method, or by disparties between useful life projections prescribed by a regulatory commission and those used by the regulated carriers. See Proposed Amendment of the Uniform System of Accounts, 48 FCC2d 876, 877-78 (1973) (discussing the effects of the Straight Line Vintage Group method).

FN332 Arthur Andersen Comments at 16; NYNEX Comments at 49, Reply at 42; Pac Tel Comments at 29; SWB Reply at 20-21; US West Comments at 52. Contra. Ad Hoc Reply at 10.

FN333 "[A] theoretical depreciation reserve (or the depreciation reserve requirement) with respect to any given class of depreciable property is that amount which, together with the estimated future depreciation accruals, will equal the service value of the property (i.e., book cost less estimated net salvage).... [R]easonable estimates of plant service lives, salvage percentages, and the resulting depreciation rates representative of future conditions must be available at the time of estimating the depreciation reserve requirement." NARUC Depreciation Text, supra note 323, at 197.

FN334 Florida Comments at 16, NYNEX Comments at 50, PacTel Comments at 28, SNET Comments at 19.

FN335 NASUCA Reply at 11-12.

FN336 Parties argue that ratepayers of regulated services enjoyed lower rates because the depreciation rates prescribed by this Commission were inappropriately low.

FN337 For instance, in Secs. 32.2210-2215.3 of this Commission's Rules, 47 C.F.R. Sec. 32.2210-2215.3, central office switching plant will be segregated into separate categories for electromechanical, electronic-analog and electronic-digital. The electromechanical account is then further separated into subaccounts to record step-by-step, crossbar and other plant.

FN338 We note that the Part 32 rules will become effective on January 1, 1988. We do not believe it necessary, however, to establish an interim allocation scheme. First, the problems stemming from discrepant allocation and depreciation reserve percentages will not become pronounced until carriers develop significant nonregulated operations supported by substantial investment. Second, while the Part 32 rules will not become effective as a matter of law until 1988, carriers are free to implement the Part 32 classification scheme voluntarily prior to that time. Finally, carriers who can demonstrate that they are harmed by the absence of an interim allocation scheme may petition this Commission for appropriate relief.

FN339 Idaho offered this proposal as one of two options. Its second option would accept a higher level of aggregation of plant.

FN340 Pac Tel acknowledges that its proposal is labor-intensive, and recommends that it be employed only when the depreciation reserve amounts at stake are "substantial." PacTel Comments at 30.

FN341 NARUC Depreciation Text, supra note 323 at 202. See also id. at 218.

FN342 Id. at 196.

FN343 See, inter alia, Depreciation Rates, 103 FCC2d 185 (1985), Depreciation Rates, 96 FCC2d 1044 (1984), Depreciation Rates, 96 FCC2d 257 (1983).

FN344 NPRM paras. 50-51.

FN345 The Alternative 2 manual would have been organized on a service-by- service basis, rather than by accounts, and would have included descriptions of the study methods used to arrive at the unit costs used in developing projected costs for each nonregulated service. NPRM para. 60.

FN346 See paras. 243-259, below.

FN347 NPRM para. 52.

FN348 MCI Reply at 14-16.

FN349 Ad Hoc Comments at 40-43; Ad Hoc Reply at 27-28.

FN350 See Ameritech Comments at 17, PacTel Reply at 12.

FN351 AT & T Structural Relief Order, 102 FCC 2d at 698-99 & n. 107.

FN352 Most of the draft manuals reflect some version of Alternative 2.

FN353 See Part VI, below.

FN354 Under Sec 220(g) of the Act, changes in accounting rules require six months lead time. We have always interpreted this rule as one for the benefit of the subject carriers, and have therefore customarily allowed carriers voluntarily to accelerate the effectiveness of accounting rule changes.

FN355 All BOCs which have been granted joint marketing waivers for protocol conversion are required to replace the accounting plans on which those waivers are based with cost allocation manuals conforming to the standards set out in this order.

FN356 Substantive changes will be subject to public comment prior to approval.

FN357 Each of these requirements is discussed in detail elsewhere in the Order. They are summarized here for convenience and clarity.

FN358 See paras. 76-78, above.

FN359 See paras. 284-301, below.

FN360 See paras. 164-73, above. The Southwestern Bell draft manual, section 5, illustrates both the level of detail we expect in the manual and an acceptable format for presenting cost category information.

FN361 NPRM, 104 FCC 2d at 84.

FN362 Id. at 85.

FN363 NTCA Comments at 13-14 and Western Union Comments at 9.

FN364 Western Union Comments at 10-11.

FN365 NATA Comments at 38-39 and DOJ Comments at 36.

FN366 Anchorage Comments at 8.

FN367 North-West Comments at 3 and Rochester Comments at 24.

FN368 North-West Comments at 3 and Rochester Reply at 14-15. See also WSTA Comments at 9.

FN369 See, e.g., NTCA Comments at 12-13, Kiesling Comments at 1, Michigan Comments at 19.

FN370 See, e.g., Bell Atlantic Comments at 12-13; NYNEX Comments at 57; SWB Comments at 41-42; Centel Comments at 16-17; GTOCs Comments at 27; United Comments at 13; MCI Comments at 20; Sprint Comments at 41; Idaho Comments at 3; Michigan Comments at 19; New York Comments at 10; Ad Hoc Comments at 43; ADAPSO Comments at 14-15; IDCMA Reply at 25; NATA Comments at 39; and Telocator Comments at 15.

FN371 U S West Comments at 44-45.

FN372 See, e.g., SNET Comments at 20.

FN373 PacTel Reply at 16 and GTOCs Comments at 27.

FN374 See, e.g., United Comments at 14, GTOCs Comments at 27.

FN375 See, e.g., IDCMA Reply at 31, Xerox Reply at 10.

FN376 See New York Comments at 10.

FN377 See, e.g., NTCA Comments at 15, AT & T Comments at 60-63, MCI Reply Comments at 56, IDCMA Reply at 27-28, NATA Comments at 40, DOJ Reply Comments at 14, Coopers & Lybrand Comments at 4-5, Arthur Andersen Comments at 12, AT & T Comments at 59-63, and USTA Comments at 22-25.

FN378 Coopers & Lybrand Comments at 4.

FN379 See, e.g., MCI Comments at 22, Xerox Reply at 9, Florida Comments at 10, US Sprint Reply at 35, and AT & T Reply Comments, App. B, Section III., at 4.

FN380 Coopers & Lybrand Comments at 4.

FN381 Coopers & Lybrand Comments at 5. Accord, PacTel Reply at 15.

FN382 See, e.g., Florida Comments at 10 and AT & T Reply App.B., Section III., at 3.

FN383 AT & T Reply App.B., Section III., at 2-3.

FN384 Id. at 4-5 and 8-9.

FN385 See NPRM, 104 FCC 2d at 82.

FN386 See id. at 83.

FN387 See id. at 84.

FN388 See id. 84.

FN389 While Coopers & Lybrand is undoubtedly correct that an audit of the amount of costs allocated to regulated and unregulated activities would involve several times the effort required for a compliance audit, there is no evidence that the cost involved would be prohibitive.

FN390 We do not expect that the manuals that carriers will submit for approval will contain a complete description of all implementation procedures. We envision a level of detail in the manuals that is comparable to the Separations Manual rather than the former Bell System Division of Revenues (DR) procedures. We do expect the independent auditors to review DR type procedures to determine whether such procedures are consistent with the carrier's cost manual and will produce accurate results.

FN391 The availability to Commission staff of the workpapers and other documentation prepared in connection with the annual audit will expedite the conduct of Commission staff audits, thus increasing the scope of the auditing work that the Commission staff can accomplish in our intensified auditing program.

FN392 An initial interim report might also be necessary. That possibility will be considered in proceedings to review the manuals that are submitted.

FN393 NPRM, 104 FCC 2d at 85.

FN394 Id.

FN395 See, e.g., Idaho Comments at 3, Pennsylvania Comments at 1, West Virginia Comments at 3, Ad Hoc Comments at 43-44, Reply at 28-30, ADAPSO Comments at 14- 15, ANPA Comments at 7, NATA Comments at 40, Telocator Comments at 15, and NASUCA Comments at 67-68, Reply at 13-14.

FN396 Western Union Comments at 10-11.

FN397 IDCMA Reply Comments at 25-26

FN398 California Comments at 12.

FN399 See, e.g., Pennsylvania Comments at 1, West Virginia Comments at 3, ANPA Comments at 7, DEC Comments at 13, Telocator Comments at 15, NATA Comments at 39-40, and IBM Reply at 19.

FN400 California Comments at 12-13.

FN401 Tennessee Comments at 2.

FN402 See, e.g., Idaho Comments at 3, Ad Hoc Comments at 43-44, ADAPSO Comments at 15, IDCMA Reply at 30, and NASUCA Comments at 67-68, Reply at 13-14.

FN403 See, e.g., Ad Hoc Comments at 43, Tennessee Comments at 2, and ADAPSO Comments at 15.

FN404 California Comments at 13.

FN405 See, e.g., Bell Atlantic Comments at 12-13, BellSouth Reply at 22-23, NYNEX Comments at 58-59, PacTel Comments at 17-18, SWB Comments at 43-45, U S West Comments

at 45, Centel Comments at 17-18, SNET Comments at 20, United Comments at 13-14, Arthur Andersen Comments at 10-12, AT & T Reply App.B., Section III., at 4-5, and Coopers & Lybrand Comments at 2.

FN406 Arthur Andersen Comments at 10.

FN407 See, e.g., Ameritech Comments at 31 and PacTel Reply at 14.

FN408 Coopers & Lybrand Comments at 2.

FN409 Coopers & Lybrand Comments at 2 and AT & T Reply, App. B, Section III, at 5.

FN410 Arthur Andersen Comments at 11.

FN411 See, e.g., Arthur Andersen Comments at 10-11, Coopers & Lybrand Comments at 3 and BellSouth Comments at 22.

FN412 See, e.g., Ameritech Comments at 30-31, BellSouth Reply at 22, PacTel Comments at 18, Centel Comments at 17, GTOCs Comments at 27, United Comments at 14, Cincinnati Bell Comments at 10 and AT & T Comments at 65.

FN413 Coopers & Lybrand Comments at 3.

FN414 US Sprint Reply at 30-31.

FN415 See, e.g., NYNEX Comments at 59 and Michigan Comments at 20.

FN416 See, e.g., SWB Comments at 44 and NYNEX Comments at 58-59.

FN417 DOJ Comments at 35.

FN418 See, e.g., GTOCs Comments at 28, Centel Comments at 17, SWB Comments at 44, Florida Comments at 9 and NYNEX Comments at 59.

FN419 See, e.g., AT & T Reply App. B, Section III., at 6 and IDCMA Reply at 28.

FN420 Florida Comments at 9; Accord US Sprint Reply at 30.

FN421 See, e.g., US Sprint Reply at 34, NYNEX Reply at 47, and Coopers & Lybrand Comments at 3.

FN422 General Standard No. 2 of AICPA's Statement of Standards for Attestation Engagements, March 1986, requires that: "The engagement shall be performed by a practitioner or practitioners having adequate knowledge in the subject matter of the assertion."

FN423 See NPRM, 104 FCC 2d at 84.

FN424 See id. at 85.

FN425 See, e.g., NYNEX Comments at 11, PacTel Comments at 17-18, SWB Comments at 7 and 42, US West Comments at 43, BellSouth Comments at 21, Anchorage Comments at 14-15, Rochester Reply at 9 and AT & T Comments at 65-68.

FN426 See, e.g., NYNEX Comments at 11, BellSouth Comments at 20, Reply at 20.

FN427 PacTel Comments at 17-18, Reply at 16-19.

FN428 SWB Comments at 42-43.

FN429 See, e.g., North-West Comments at 3, WSTA Comments at 9 and AT & T Reply App.B., Section III., at 9.

FN430 See, e.g., NYNEX Comments at 11.

FN431 See, e.g., NYNEX Reply at 45, PacTel Comments at 18 and BellSouth Comments at 23.

FN432 See, e.g., ADAPSO Comments at 16 and NATA Reply at 17.

FN433 See ADAPSO Comments at 16.

FN434 See, e.g., DOJ Reply at 13, NATA Reply at 17, West Virginia Comments at 5, MCI Comments at 21 and ATAE Reply at 9.

FN435 See, e.g., Tennessee Comments at 2, Ad Hoc Reply at 32-33, CBEMA Reply at 10-11, DEC Comments at 12, NATA Reply at 18-19, Telocator Reply at 16, NASUCA Comments at 67-68 and Motorola Reply at 13-14.

FN436 See, e.g., Ad Hoc Reply at 32 and Telocator Reply at 16.

FN437 See, e.g., DOJ Reply at 12-13, Ad Hoc Reply at 33.

FN438 See, e.g., DEC Comments at 12.

FN439 See, e.g., CBEMA Reply at 10-11.

FN440 See, e.g., Telocator Reply at 16 and ANPA Comments at 8.

FN441 See, e.g., Ad Hoc Reply at 32-35, ANPA Reply at 5-6, IDCMA Reply at 43-44 and US Sprint Reply at 34.

FN442 See, e.g., ADAPSO Comments at 16, ATAE Reply at 8-9, DEC Comments at 12, NATA Reply at 17 and Telocator Reply at 15-16.

FN443 See, e.g., Ad Hoc Reply at 32.

FN444 NASUCA Comments at 67-68.

FN445 See, e.g., MCI Comments at 22, Florida Comments at 9, Michigan Comments at 20, IDCMA Comments at 28, Telocator Reply at 15-16, DOJ Comments at 35 and Coopers & Lybrand Comments at 5-6.

FN446 See Coopers & Lybrand Comments at 6 and AT & T Reply App. B, Section III., at 7-8.

FN447 Florida Comments at 9.

FN448 We are also amending Part 32 of our Rules herein, which is the revised USOA scheduled to become effective on January 1, 1988. The new section 32.23 will include instructions identical to those set forth in sections 31.01-10. Although we did not propose in the NPRM to amend Part 32, this action is proper without further notice and comment procedures. This change simply continues the effectiveness of the instructions after Part 31 is deleted on December 31, 1987, and as such is a "housekeeping" change in our rules. Further notice and comment is unnecessary. See 5 U.S.C. Sec. 553(b), 47 C.F.R. Sec. 1.412(c).

FN449 See Computer II Final Decision, note 27, supra. A similar requirement exists for certain transactions between cellular radio companies and their affiliates, although we have relaxed the contract filing requirements for such transactions. See 47 C.F.R. Sec. 22.901(c)(3).

FN450 See Comments of Compuserve, Michigan PSC, IBM, IDCMA, ICA, DOJ, ADAPSO, AdHoc, Idaho PSC, DCPSC, NATA, IIA and West Virginia PSC.

FN451 See, e.g., DOJ Comments at 41; AdHoc Comments at 31-32; ADAPSO Comments at 17-18.

FN452 See, e.g., Comments of Bell Atlantic, BellSouth, NYNEX Anchorage, Granite,

OPASTCO, SNET, AT & T.

FN453 Democratic Central Committee v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C.Cir.1973), cert. denied, 415 U.S. 935 (1974).

FN454 See AT & T Comments at 57-58.

FN455 See, e.g., SNET Comments at 21-22; Contel Comments at 17.

FN456 See, e.g., NYNEX Comments at 41-46; Rochester Comments at 30-34 (FCC should defer to states in this area); USTA Comments at 12-13.

FN457 See, e.g., Centel Comments at 13-15.

FN458 See generally Comments of Centel, Contel and Pacific. Commenters raised a variety of issues as to the determination of "cost."

FN459 See US West Comments at 55. In its Reply at 23-25, Southwestern Bell notes that other parties define market value to include volume discounts.

FN460 See, e.g., NYNEX Comments at 42.

FN461 See, e.g., AT & T Structural Relief Order, Computer III Report and Order and BOC Structural Relief Order.

FN462 These rules will, of course, be applicable to some carriers that were never subject to Computer II structural separation requirements. Standards for their affiliate transactions are essential to provide adequate protection for ratepayers.

FN463 Rochester Comments at 30-34.

FN464 See WSTA Comments at 5; Wisconsin PSC Comments at 4.

FN465 See US West Comments at 55.

FN466 The term "asset" encompasses any item that would be recorded in an investment account of the regulated carrier.

FN467 AT & T Comments at 56.

FN468 See, e.g., CBEMA Reply at 5-6.

FN469 We reject Centel's position that cost must be used in the absence of price lists or tariffs because "establishing a fair market price is speculative." (Centel Comments at 15.) Although establishing fair market value requires some degree of subjectivity, there are methods of valuation which are readily available to the carriers, such as competitive bids, appraisals, market surveys, etc.

FN470 485 F.2d 786 (D.C.Cir.1973).

FN471 We also note that the carriers may not now be following a uniform valuation approach for assets transferred in and out of regulation. See, e.g., Pacific Comments at 34.

FN472 On the other hand, we note that there may be sharing arrangements in which a separate company uses plant which belongs to the regulated company and which is accounted for in regulated accounts. Such arrangements do not constitute asset transfers; they must instead satisfy the requirements of our cost allocation rules.

FN473 See Idaho PSC Comments at 6. Pacific is concerned that our approach "may be too general." It states that the tax allocation methodology should produce "high quality results believed to be needed to comply with the tax normalization requirement for ratemaking proceedings in the regulated entities." Pacific Comments at 35. Our review of Pacific's tax allocation narrative and the allocation illustration, however, indicates that the NPRM's procedures produce the same results. Accordingly, we see no need to describe the allocation procedure in less general terms.

FN474 ADAPSO Comments at 19-21, Ameritech Comments at 24, ANPA Reply at 4, ATAER Reply at 8-9, NCTA Comments at 10, SNET Comments at 24-25, Telocator Comments at 13, Xerox Reply at 14-15. Cf. AT & T Comments at 50-53; Reply at 36; Reply, Appendix B, at 30-31 (opposing Alternative 2 and proposing a modified Alternative 1).

FN475 ICA Comments at 8.

FN476 AT & T Comments at 51, Reply at 36; NYNEX Comments at 27-28; PacTel Comments at 41; SWB Comments at 29-30.

FN477 AT & T Comments at 51, citing this Commission's statement that "accounting for nonregulated activities is within the purview of carrier management", in Revisions of the Uniform System of Accounts for Tel. Cos. to Accommodate Generally Accepted Accounting Principles, 102 FCC 2d 964, 988 (1985) (USOA Revision Order).

FN478 Ad Hoc Comments at 22, Reply at 8; Anchorage Comments at 13-14; Bell Atlantic Comments at 14-15; DCPUC Comments at 7; Florida Comments at 21-22; ICA Comments at

7-8; Idaho Comments at 7; Granite Comments at 10; GTOCs Comments at 34; Michigan Comments at 10; Missouri Comments at 24; New York Comments at 7-9; PacTel Comments at 40-43, US West Comments at 67-68, Reply at 12-13.

FN479 Bell Atlantic Comments at 14-15, BellSouth Comments at 26, California Comments at 23, NYNEX Comments at 25-29, SWB Comments at 29-31. See IBM Comments at 27 (arguing that subsidiary ledgers can effect the requisite separation of regulated and nonregulated costs). Contra AT & T Comments at 51- 53.

FN480 SWB Comments at 28-30.

FN481 See also SWB Comments at 26.

FN482 IBM Comments at 29, AT & T Reply at 39-40, US Sprint Comments at 9-12 (Raising the same complaint against both Alternatives 1 and 2). Contra, PacTel Reply at 30 (arguing that investment risk is a rate base issue, not an allocation issue).

FN483 IBM Comments at 29, US Sprint at 12, AT & T Reply at 37-38. Contra PacTel Reply at 30.

FN484 AT & T Comments at 52-53. See also Arthur Andersen at 19.

FN485 AT & T Comments at 52. See also NATA Comments at 30. Contra, BellSouth Reply at 14-15.

FN486 DEC Comments at 10-11, Reply at 9 n. 22. See also ATAE reply at 8.

FN487 AT & T Comments at 49-50, Reply at 35-40; IBM Comments at 29-30; US Sprint Comments at 9-10, 16. Contra SWB Comments at 29.

FN488 AT & T Reply at 37-38, citing FASB Statement of Financial Standards No. 14, Financial Reporting for Segments of a Business Enterprise, para. 10(e) and Accounting Principles Board Statement No. 4, para. 116.

FN489 Rochester Comments at 37, WSTA Comments at 11.

FN490 US Sprint Comments at 14-15.

FN491 US Sprint Comments at 15-16.

FN492 Arthur Andersen Comments at 18, NYNEX Reply at 8.

FN493 Alabama Comments at 1-2.

FN494 Arkansas Comments at 27-28.

FN495 Joint Telcos Comments at 4.

FN496 Rochester Comments at 16.

FN497 Contel Comments at 17-18.

FN498 Because we are rejecting Alternative 1, we need not address the AT & T arguments that Alternative 1 does not comport with our USOA Revisions Order.

FN499 In identifying such common investment, we will employ a standard of reasonableness that will exclude from this category costs that are clearly de minimis or costs related to plant that will have only occasional common use. Our purpose in applying this standard of review is to ascertain that the investment exhibits a bona fide nexus to both regulated and nonregulated activities. Investment that fails to meet this standard will be treated as dedicated investment. Dedicated, nonregulated investment and related revenues and expenses will be recorded in Accounts 317 and 106.

FN500 We note that, as discussed in Part 3, supra, these accounting and reporting requirements will apply to services that have never been subject to regulation or that have been preemptively deregulated.

FN501 In their comments, several BOCs indicated their willingness to establish detailed subaccounts to record nonregulated portions of common non-network costs. We will not require a specific format for such subaccounts at this time, but we do emphasize that such subaccounts should be clearly related to the relevant accounts. We do not endorse SWB's proposal to establish "service specific" subaccounts for this purpose. SWB Comments at 31. Subaccounts based on such a classification would be inconsistent with the functional cost categories discussed supra at paras. 165-175. These cost categories, which are an integral part of the accounting and allocation scheme adopted in this Order, are derived from account classifications.

FN502 We note that the record contains no evidence in support of DEC's assertion that diseconomies of scope will arise as a result of carriers' ventures into nonregulated services, or that separate books of account are required to identify such costs if they do, in fact, develop.

FN503 Rochester Comments at 37.

FN504 Nationwide, investment in DDS circuit equipment totals in excess of $500 million.

FN505 In 1986, for example, our studies show DDS circuit equipment lives to be nearly 80 percent that of standard circuit equipment lives.

FN506 See generally, Authorized Rates of Return for the Interstate Services of AT & T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Phase II, FCC 86-353 (Released August 25, 1986); Phase III, FCC 86-354 (released August 25, 1986). (Both Orders discuss at length the effects of business risk associated with interstate and intrastate services.)