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BY THE U.S. GENERAL ACCOUNTING OFFICE

# Report To The Honorable Ernest F. Hollings United States Senate

# Status Of Federal Communications Commission Efforts To Allocate Costs Between Telephone Companies' Regulated And Unregulated Activities

This report reviews Federal Communications Commission efforts to ensure that the regulated ratepayer does not bear a disproportionate share of the costs of telephone companies' unregulated activities. It contains information on

--the potential for the 22 local telephone companies--now a part of the Bell System--to act anticompetitively after their divestiture in January 1984 and

--FCC's progress in developing accounting systems and cost allocation procedures to reasonably separate the costs of regulated and unregulated activities.

UNITED STATES GENERAL ACCOUNTING OFFICE

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GAO/RCED-83-235
SEPTEMBER 2, 1983

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

B-212866

The Honorable Ernest F. Hollings
United States Senate

Dear Senator Hollings:

In response to your letter of May 19, 1983, we have obtained information on efforts by the Federal Communications Commission (FCC) to ensure that the telephone ratepayer does not bear a disproportionate share of the costs of telephone carriers' unregulated activities. You were especially concerned about the outcome of two FCC proceedings that were considering whether, after the breakup of the Bell System, the 22 Bell operating companies (BOCs),[1] Southern New England Telephone Company, and Cincinnati Bell, Inc., should be required to offer unregulated products and services through a separate subsidiary, as FCC required of American Telephone and Telegraph Company (AT&T). You noted that without a separate subsidiary, the need for accounting procedures to measure and allocate costs between regulated and unregulated activities takes on increased importance. However, you were concerned about FCC's ability to develop such procedures because of its lack of past success.

As agreed with your office, we focused on providing information on the viewpoints of various parties regarding the potential for the BOCs to act anticompetitively and the need for a separate subsidiary in addition to information on FCC's efforts to revise the uniform system of accounts (USOA)[2] and develop cost allocation procedures that could be used by the BOCs to reasonably separate costs of their regulated and unregulated activities.

As you are aware, the question of what regulatory requirements should be imposed on the BOCs by FCC results from a series of Federal actions made in response to dramatic changes in

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[1]The 22 BOCs are listed in table 3 in appendix I.

[2]The USOA that FCC requires for telephone companies under its jurisdiction provides a means for classifying, recording, interpreting, and reporting a carrier's financial information. As such, it is a fundamental source of information for FCC.

telecommunications technology. These actions include FCC's decisions to allow regulated carriers, under certain conditions, to sell unregulated products and services, and the 1982 antitrust settlement between AT&T and the Department of Justice[3] which will require AT&T on January 1, 1984, to divest its local telephone exchange operations, which were provided by the BOCs.

FCC has struggled for years with the problem of how to ensure that carriers' costs are properly allocated (between regulated and unregulated products and services, as well as among regulated services) to protect telephone ratepayers. Our review of FCC's current efforts to deal with this problem showed that although FCC is making progress, much work remains before adequate accounting systems and cost allocation procedures are adopted. FCC is moving ahead with its revision of the USOA, but implementation is not scheduled until January 1986; it has given conditional approval to AT&T's cost allocation procedures, but is continuing to review their use; and it now is considering cost allocation procedures for other telephone companies. The effectiveness of these efforts when completed will depend to some extent on the resources dedicated to monitoring compliance with accounting requirements. FCC's Common Carrier Bureau believes its current audit staff is inadequate to audit the BOCs after divesture and has requested additional resources for fiscal year 1985.

## BACKGROUND

Technological changes in the domestic common carrier telecommunications industry have prompted a reaction on the part of FCC to remove regulatory restrictions and foster competition. One major decision to implement this new policy was FCC's Computer II decision (Docket 20828), adopted in 1980, which allows the long-established, regulated carriers to participate in new and emerging unregulated product and service markets.

While FCC recognizes the benefits of competition--increased innovation, the introduction of new techniques and services, and potentially lower costs--it also recognizes that it must guard against possible abuses. When a firm conducts both regulated and unregulated activities, it has the incentive and the potential to engage in certain anticompetitive practices, including cross-subsidization of unregulated activities with excess profits earned from regulated activities. This is accomplished by loading the costs of shared services more heavily on the regulated side where they are recovered through the ratemaking process. This imposes a financial burden on the captive customers of the firm's regulated activities.

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[3]United States v. American Telephone and Telegraph Co., 552 F. Supp. 131 (1982).

In its Computer II decision, FCC adopted two basic regulatory safeguards to minimize the dangers of anticompetitive practices, including cross-subsidization. These safeguards are structural separation and accounting systems. Structural separation requires that the regulated firm establish a separate subsidiary for unregulated products and services. FCC has required only AT&T to set up a separate subsidiary. The other carriers were required only to maintain separate books of account for regulated and unregulated activities.

FCC maintains that a separate subsidiary has certain advantages over accounting requirements alone in reducing the ability of a firm to engage in anticompetitive behavior without being detected. For example, by reducing the amount of common costs between affiliated entities, a separate subsidiary lessens FCC's problem of prescribing appropriate cost allocation procedures and monitoring their implementation. In spite of a separate subsidiary's advantages over accounting systems alone, FCC has been restrained in imposing this requirement because of its belief that the costs associated with establishing a separate subsidiary often exceed its benefits. FCC believes that generally the benefits of a separate subsidiary outweigh the costs only for the larger carriers.

The 1982 agreement to settle the Department of Justice's antitrust action against AT&T has raised the question of how the regulatory scheme established in FCC's 1980 Computer II decision should be applied to the BOCs. BOCs are to be divested from AT&T beginning on January 1, 1984, according to the settlement. In February 1983, FCC reached a decision to waive the separate subsidiary requirement for two AT&T affiliates--the Southern New England Telephone Company and Cincinnati Bell, Inc.--on the basis that after the antitrust settlement is implemented, they will possess insufficient market dominance. These two companies, unlike the 22 BOCs, are not majority-owned subsidiaries of AT&T.

A more detailed description of these regulatory and antitrust actions is contained in appendix I.

## FCC CONSIDERING SEPARATE SUBSIDIARIES FOR DIVESTED BOCs

FCC is now considering in a rulemaking proceeding (Docket 83-115) whether and to what extent the separate subsidiary requirement, which currently applies to AT&T, should apply to the BOCs after their divestiture. The essential question in this proceeding is whether the BOCs, after divestiture, will possess an ability and incentive for anticompetitive behavior which will outweigh certain costs associated with establishing and operating a separate subsidiary for unregulated activities.

Many of the parties that filed comments in the proceeding stated that the incentives and opportunities for the BOCs to be anticompetitive were sufficient to require a separate subsidiary. A variety of telecommunications interests and the Department of Justice took this general position. They argued that the BOCs' control over local exchange facilities could be used to disadvantage competitors who required access to the local exchange. On the other hand, a few commenters, including AT&T, argued that the circumstances did not call for separate subsidiaries because the Bell System at which structural separation was aimed will cease to exist after divestiture. They said that the divested BOCs will be comparable in pertinent characteristics to other independent telephone companies, yet are under constraints of the settlement agreement, and will not be able to re-create a unified system to engage in anticompetitive behavior. The States commenting in the docket said that the imposition of separate subsidiaries on the BOCs should be left to them, rather than to FCC. Appendix II provides additional information on the viewpoints of commenters to this proceeding regarding the potential for the BOCs to act anticompetitively and the need for a separate subsidiary.

## FCC's EFFORTS TO REVISE THE USOA

To help prevent improper cost allocations, accounting systems and cost allocation procedures are needed so that financial data can be properly identified and recorded and costs reasonably allocated between regulated and unregulated activities.

Because it is based on out-dated technology and focuses on companywide results, rather than individual services, the current USOA adopted in 1935 has proved to be of little, if any, help in providing useful cost information. Consequently, since 1978 FCC has been working to revise the USOA so that it will provide more useful regulatory information. After several years of little progress, FCC renewed its efforts to revise the USOA beginning with a "Second Supplemental Notice of Proposed Rulemaking and Order" issued in October 1981. Since then the effort to revise the USOA has progressed, but much work remains before the scheduled implementation date of January 1, 1986. For example, work to develop the accounting structure along with related definitions and rules is not completed; the proposed system will be released for two rounds of comments by interested parties; and FCC will need to review the proposed system and consider relevant comments.

Even after the USOA is implemented, however, it will be essentially a financial accounting system[4] and not the multifaceted cost accounting and data management system originally proposed in 1978. Under FCC's current approach, rather than incorporating costing and pricing methodologies within the financial accounting system per se, FCC intends to develop cost-of-service information by applying costing rules and procedures developed in other proceedings to the financial data contained in the revised USOA. Additional information on FCC's efforts to revise the USOA is contained in appendix III.

## FCC's EFFORTS TO DEVELOP COST ALLOCATION PROCEDURES

FCC has two major efforts underway which deal with cost allocation procedures for regulated and unregulated activities. One proceeding involves procedures only for AT&T; the other proceeding involves procedures for other carriers (the independent telephone companies).

In its Computer II decision requiring a separate subsidiary for AT&T's unregulated activities, FCC chose to allow sharing of certain services which would support both regulated and unregulated activities. For example, FCC has allowed AT&T to share with its subsidiary certain corporate administrative services such as legal, financial, and personnel.

FCC has not prescribed final cost allocation procedures for AT&T's shared services. Generally, FCC's approach has been to allow AT&T to develop and implement its own accounting procedures subject to review and approval by FCC. During the past year and a half, FCC and AT&T have been engaged in a back-and-forth process to correct problems identified by FCC and develop acceptable accounting procedures. FCC has conditionally approved these procedures; however, it is still reviewing the need for further adjustments.

In the second proceeding, FCC issued a Notice of Proposed Rulemaking on June 21, 1983, proposing certain changes to the account structures of the independent telephone companies--for example, eliminating certain accounts and adding others--to better account for unregulated operations. The proposal, however, does not prescribe cost allocation procedures, although it does request interested parties to suggest appropriate procedures. The

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[4]In its October 1981 notice, FCC described a financial accounting system as the general purpose financial statements and underlying books of account which an enterprise maintains in accordance with the common set of accounting concepts, standards, and procedures called generally accepted accounting principles which are recognized by the accounting profession as a whole.

procedures established will be effective 6 months after the issuance of the final order, expected later this year. Until that time, carriers may use any reasonable method to account for unregulated equipment and services separately from their regulated operations. FCC has not, however, reviewed any carrier's current accounting systems or cost allocation procedures.

Additional information on FCC's efforts to develop adequate cost allocation procedures for AT&T and other carriers is contained in appendix IV.

MONITORING CARRIER COMPLIANCE

When procedures are approved for AT&T and the other carriers, including the BOCs, monitoring will be necessary to verify that the procedures are implemented as approved. The importance of monitoring has been stressed by FCC in various proceedings and by AT&T's independent auditor. FCC has a current staff of about 14 auditors who have generally been restricted to auditing AT&T locations in Washington, D.C., and New York City because of limited travel funds.

FCC's Common Carrier Bureau, in its budget proposal for fiscal year 1985, stated that after the breakup of AT&T "the Commission's current audit resources will clearly be inadequate to maintain the current level of auditing." As a result of the Bureau's concern, FCC is asking for an increase of six auditors for 1985 in addition to $20,000 in travel funds, primarily to audit the BOCs after divestiture. This would permit triennial audits of each of the seven regional holding companies into which the BOCs will be grouped after divestiture. However, these audits will need to review BOCs' compliance with other regulatory requirements besides cost allocation procedures. For example, FCC will have to review how the BOCs are charging customers for their interstate costs.

Two possible approaches which could assist FCC in monitoring carriers' compliance with prescribed cost allocation procedures are the adoption of cost accounting standards and evaluations by independent auditing firms of whether carriers' cost allocation procedures are reasonable and proper. We believe that these approaches offer the potential for increasing FCC's ability to determine whether the costs of shared services are properly allocated between regulated and unregulated activities whether or not a separate subsidiary is required.

Cost accounting standards are a body of 19 standards promulgated by the former Cost Accounting Standards Board[5] covering virtually all aspects of cost accounting. While the standards are required for national defense contracts, they are designed for an accounting system where it is necessary to trace expenses to final cost objectives on a beneficial or causal relationship. The standards provide criteria for defining and measuring costs and the methods by which costs are to be allocated to cost objectives. Consequently, standards such as those dealing with allocation of direct and indirect costs and general and administrative expenses may be applicable to telephone companies and would provide a consistent basis upon which to allocate costs among various telecommunications activities. However, these standards alone may not be an adequate substitute for a separate subsidiary requirement if a carrier has strong incentives for anticompetitive behavior.

As a way to help monitor carrier compliance with these standards and other accounting requirements, FCC may also want to consider the use of independent auditing firms to evaluate the adequacy of carriers' accounting procedures for properly allocating costs. The Chief, Common Carrier Bureau, told us that although evaluations by auditing firms or contractors was an option worth considering, it was likely to be costly. He also noted, however, that it would be difficult to estimate the cost of this approach.

Additional information on these two approaches and FCC's plans for increasing its audit staff are included in appendix IV.

## OBJECTIVES, SCOPE, AND METHODOLOGY

Our objective was to obtain information to respond to the questions posed in your request letter. To obtain this information, we used as a starting point our three prior reports[6] dealing with accounting and regulatory issues facing FCC. These reports dealt with FCC's efforts to develop effective accounting systems, the advantages and limitations of separate subsidiaries, and FCC's implementation of its Computer II decision.

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[5]The Cost Accounting Standards Board was an agency established by the Congress to promulgate cost accounting standards designed to achieve greater uniformity and consistency in the cost accounting practices followed by defense contractors.

[6]"Outlook Dim for Revised Accounting System Needed for Changing Telephone Industry" (FGMSD-80-9, Nov. 13, 1979); "Legislative and Regulatory Actions Needed To Deal With a Changing Domestic Telecommunications Industry" (CED-81-136, Sept. 24, 1981); and "Can the Federal Communications Commission Successfully Implement Its Computer II Decision?" (CED-82-38, Jan. 29, 1982).

To obtain viewpoints regarding the potential for BOCs to act anticompetitively and the need for a separate subsidiary, we reviewed comments filed in Docket 83-115 by carriers, State public utility commissions, and other interested parties. We also interviewed FCC staff knowledgeable about this docket, Computer II requirements, and related accounting issues.

Our assessment of progress made in revising the USOA included a review of relevant records such as quarterly reports to FCC, minutes of committee meetings, a status report submitted to the Congress in August 1982, and the FCC order setting forth the objectives and design concept for the revised system. We discussed the revision effort with the Chief of the USOA staff and the Chief of the Accounting and Audits Division.

Information on FCC's progress in developing cost allocation procedures was obtained by reviewing relevant documents in two proceedings--one dealing with procedures for AT&T and the second for non-AT&T telephone companies. We used these documents to obtain an understanding of AT&T's proposed procedures and FCC staff's concerns with those procedures. We also discussed these two proceedings and FCC's auditing capability with officials in FCC's Common Carrier Bureau.

We conducted our work from June through August 1983 at FCC headquarters in Washington, D.C. At your request we did not take the additional time to obtain agency comments on matters discussed in this report. However, material contained in the report was discussed with FCC Common Carrier Bureau officials, and their comments were included where appropriate. With the exception of not obtaining official agency comments, our review was performed in accordance with generally accepted government auditing standards.

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As arranged with your office, we are sending copies of this report to the Chairman, Federal Communications Commission; the Director, Office of Management and Budget; interested congressional committees, subcommittees, and individual Members of Congress; and other interested parties. Copies will be available to others on request.

Sincerely yours,

Ralph V. Carlone for

J. Dexter Peach
Director

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## ABBREVIATIONS

| | |
|---|---|
| AT&T | American Telephone and Telegraph Company |
| BOCs | Bell operating companies |
| CAS | cost accounting standard |
| CBI | Cincinnati Bell, Inc. |
| CPE | customer-premises equipment |
| CSO | central staff organization |
| FCC | Federal Communications Commission |
| GAO | General Accounting Office |
| GTE | General Telephone and Electronics Corporation |
| SNET | Southern New England Telephone Company |
| USOA | Uniform System of Accounts |

# GLOSSARY

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| Access charges | Charges to carriers offering interexchange services to cover local exchange costs associated with the origination and termination of such services. |
| Basic services | Traditional "pipeline" transmission services. |
| Common carrier | A company, organization, or individual providing wire or electronic communications services for hire. |
| Cross-subsidy | The contribution of profits by one telecommunications service priced above its cost made to defer the cost of another telecommunications service priced below its cost. |
| Customer-premises equipment | Equipment, ranging from telephones to computer terminals, which is located at the customer's premises and attached to the communications network. |
| Docket | The record of a proceeding which is assigned a docket number for administrative control purposes. |
| Dominant | Used in relation to a firm in an industry which controls a significant portion of total industry output. |
| Enhanced service | A service which involves more than the pure transmission of information. |
| Interexchange service | Long distance or toll telecommunications service, as distinguished from local telephone service. It includes both intrastate and interstate toll service. |
| Interstate service | Telecommunications services between States. Such service presently falls under the Federal Communications Commission's jurisdiction. |
| Intrastate service | Service offered within the boundaries of a State, including both local and toll service. Such service presently falls under the jurisdiction of State regulatory commissions. |
| License contract | An arrangement in which an organization within a major telephone system provides certain services to associated telephone companies on a cost-allocative basis. |

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| Local exchange | Telephone service for single-line business service and residence customers which provides the capability for originating calls to a defined local calling area, for receiving incoming calls, and for access to and from the toll network. |
| Natural monopoly | An industry in which economies of scale are so pronounced that competition among firms results in a monopoly by the largest firm. |
| Network | A system where a number of terminal points are able to access one another through a series of communications lines and switching arrangements. |
| Tariff | A statement filed by a telecommunications common carrier with the appropriate public regulatory agency which describes the service it offers and lists a schedule of charges for the use of that regulated telecommunications. |
| Telecommunications | The transmission of signals of any kind by wire, radio, optical or other electromagnetic systems. |
| Uniform system of accounts | An accounting system prescribed by the Federal Communications Commission for domestic common carriers. |
| Vertical integration | Combining firms at different stages of the production process into one business unit. |

## BACKGROUND ON FEDERAL ACTIONS CAUSING GREAT CHANGE IN THE TELEPHONE INDUSTRY

The structure of the telephone market in the United States has changed radically in the last 4 years as the result of two separate but interrelated Government actions. In this appendix we will provide background information on the two actions, their causes and results, and show how they, in conjunction with technical advances in the industry, have created the current issues discussed in our report to Senator Hollings and in the following appendixes.

First, the Federal Communications Commission (FCC) is implementing its April 1980 decision in the Second Computer Inquiry (Computer II) (77 FCC 2d 384, 1980) that attempts to draw a boundary between regulated "basic" telephone services involving pure transmission of information and unregulated "enhanced" service made possible by the telephone industry's rapidly evolving computer and electronic technology. To protect the ratepaying consumer from anticompetitive behavior, such as the cross-subsidy of the competitive business with monopoly revenues, FCC, in Computer II, required American Telephone and Telegraph Company (AT&T) to establish a separate subsidiary to provide competitive enhanced services and the deregulated customer-premises equipment (CPE).[1]

The second action was the January 1982 agreement between the Department of Justice and AT&T to end a 7-year-old antitrust suit.[2] This settlement, scheduled to take effect January 1, 1984, restructures the Bell System by requiring the divestiture of the 22 Bell operating companies (BOCs) that provide local telephone service and which provided AT&T with monopoly power (see list in table 3). The settlement raises the question of how the Computer II regulatory scheme should be applied to the BOCs.

Although these actions were taken separately, they both have a major impact on the Bell System and its future ability to wield monopoly power as the dominant telephone service and equipment provider in the United States. In addition to these decisions that are reshaping the domestic telecommunications market, a continuing force, which created the need for the FCC's Second Computer Inquiry, is the rapid pace of technological development in both telecommunications hardware and software.

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[1]Telephones or other apparatus located on the customer's property connected for use on the communications network.

[2]<u>United States</u> v. <u>American Telephone and Telegraph Co.</u>, 552 F. Supp. 131 (1982).

Advancing technology spurs Computer II decision

Because computers used for communications services increasingly have the capability of performing data processing services, FCC has had to decide whether and how common carriers should be allowed to market such services. The issue was first addressed in the First Computer Inquiry (Computer I) (28 FCC 2d 267, 1971) of the 1966-71 period in which FCC adopted definitions intended to distinguish between unregulated data processing and permissible use of computers to provide regulated communications services.

Because of concern that common carriers could engage in anticompetitive or discriminatory practices in their marketing of the unregulated services, FCC's 1971 Computer I decision required the carriers with over $1 million in revenue to use a separate corporate entity. Technological developments soon rendered FCC's proposed definitional solution unworkable, however, and forced it to reexamine the approach to regulatory problems resulting from the interplay of data processing and communications. FCC said the "dramatic advances" in technology, which compelled the reexamination beginning in 1976, involved the use of integrated circuitry and microprocessor technology. It allowed users to decentralize computing power and perform both data processing and communications control within the common carrier network and at the customer's premises. FCC also considered the question of how to regulate the customer-premises equipment used to receive or process the information delivered by the common carrier service, which had traditionally been included in the rates of regulated services provided by the telephone companies.

After taking 4 years to issue a Notice of Inquiry and Proposed Rulemaking, a Supplemental Notice, and a Tentative Decision and receiving rounds of comments on these documents, FCC arrived at its final decision in April 1980. The decision introduced the enhanced versus basic service definitions and set forth a regulatory scheme under which carriers deemed to be dominant in the provision of enhanced services and CPE are required to establish separate subsidiaries for these businesses. The requirement is intended to act as a regulatory tool to help prevent anticompetitive conduct--for example, by allowing easier detection of carriers' subsidy of unregulated activities with their regulated revenues. In contrast with the Computer I decision, FCC, in its Computer II decision, chose to apply the separate subsidiary requirement to only those carriers which it believed had significant market power that could be exercised to the detriment of communications ratepayers and the competitive evolution of enhanced services on a national scale. Originally, FCC planned to apply the requirement to AT&T and General Telephone and Electronics Corporation (GTE) but, in a reconsideration decision (84 FCC 2d 50, 1980), removed the requirement from GTE. In regard to GTE, FCC concluded that the benefits to the public of a structural separation requirement did not outweigh other public considerations.

FCC said that it reversed itself on reconsideration because GTE advanced persuasive arguments as to why it should not be subject to separation for enhanced service and CPE. Concerning enhanced services, the most compelling argument was that GTE is dependent on AT&T for the vast majority of its interstate transmission needs. In regard to CPE, FCC accepted GTE's argument that its local exchange operating territories are predominantly rural. FCC chose to regulate the potential abuses of GTE and the others through a requirement for separate books of account, which involves recordkeeping only, as opposed to creation of a whole organization as a separate subsidiary. FCC kept the option of changing this approach if future circumstances warranted.

In the Computer II final decision and two reconsiderations, FCC put certain restrictions on the relationship between AT&T and the separate subsidiaries it was to establish. For example, FCC prohibited the enhanced service subsidiary of AT&T from owning and operating transmission facilities--it must obtain such capacity on the same basis as a competitor. The subsidiary was also required to maintain separate books of account and to do its own marketing to guard against cross-subsidy[3] and other anticompetitive dealings with AT&T.

The Computer II separate subsidiary requirement took effect for AT&T on January 1, 1983, with the establishment of a subsidiary which took over the sale of equipment and enhanced (computer) services from the Bell operating companies.

For GTE and the other independent telephone companies which are exempted from Computer II's separate subsidiary requirement, the decision allowed the carriers the option of offering CPE and enhanced services through their existing corporation or through a separate subsidiary. However, these independent telephone carriers must use separate books of accounts for the unregulated activities if they offer them. The exact accounting procedures they must follow have yet to be finally prescribed by FCC. See a comparison of the relative size of GTE, the BOC regions, and other companies in table 1, page 8.

## The antitrust settlement

On January 8, 1982, AT&T and the U.S. Department of Justice announced an agreement to settle a long-pending antitrust action of the Government against the telephone monopoly by restructuring the company through divestiture.

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[3]See glossary.

The agreement splits the company apart, creating seven new independent regional holding companies to provide local telephone service through the 22 Bell operating companies. According to AT&T's Plan of Reorganization of December 16, 1982, recently approved by the U.S. District Court of the District of Columbia, the seven companies will hold all of the BOCs' stock.[4] The regional companies will be independent of one another and of AT&T. A central staff organization (CSO) will augment BOC and regional holding company capabilities with central technical and support services to perform a broad range of functions pertaining to design and operation of exchange networks. The regional groups will be roughly the same size in terms of assets and large enough to generate broad interest in the investment community.

The antitrust suit settlement creates significantly different circumstances from those that existed when FCC came to its decisions in the Computer II Inquiry. Then, the AT&T Bell System was one unit, and the separate subsidiary requirement for provision of CPE and enhanced services was applied only to AT&T because it met these four criteria that FCC believed might allow anticompetitive behavior:

--A carrier's ability to engage in anticompetitive activity through control over "bottleneck" facilities, i.e., local exchange and toll transmission facilities, on a broad national geographic basis.

--A carrier's ability to engage in cross-subsidization to the detriment of the communications ratepayer.

--The integrated nature of the carrier and affiliated entities, with special emphasis on research and development and manufacturing capabilities that are used in conjunction with, or are supported by, communications-derived revenues.

--The carrier's possession of sufficient resources to enter the competitive market through a separate subsidiary.

With the divestiture of the BOCs into the seven regional holding companies, FCC must decide whether the separate subsidiary requirement placed on AT&T should continue to apply to the BOCs. On February 17, 1983, FCC issued a Notice of Proposed Rulemaking in Common Carrier Docket No. 83-115 on this question. A decision is expected sometime this fall. (See discussion on this proceeding in app. II.)

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[4] United States v. Western Electric, No. 82-0025 (July 8, 1983).

In addition to the fact that the BOCs will be spun off from AT&T as separate, independent entities as a result of the settlement, limitations placed on the BOCs by the court in the final order on the antitrust case enter into the decision as to whether the public benefit from application of the Computer II standard outweighs the costs.

The conditions agreed to by the parties, then modified and approved by the court, which are intended to prevent anticompetitive conduct by the BOCs, include

--permission to provide, but not manufacture, customer-premises equipment;

--prohibition from providing interexchange (long-distance) services;

--denial of the opportunity to provide "information services"; and

--general prohibition from providing any other product or service, except exchange telecommunications and exchange access service, that is not a natural monopoly service actually regulated by tariff. (Yellow page directories by the BOCs were allowed, however.)

The antitrust settlement as originally proposed in January 1982 had prohibited the BOCs from selling or leasing CPE. After hearing comments and arguments on the proposal, the U.S. district court modified the settlement allowing BOCs to market CPE.[5] The court concluded that such marketing "presents little potential for anticompetitive behavior" because of the difficulty of a BOC conspiring with a separate manufacturer to provide anticompetitive advantage or cross-subsidization. The court noted that the slight risks to competition of BOCs' marketing CPE may be outweighed by their counterbalance to AT&T market strength. Under the proposed decree, AT&T, through its subsidiary, will retain both the existing (embedded) CPE and the network of retail outlets.

Although the court was urged, in the event it allowed BOCs into competitive activities, that they be required to do so through a separate subsidiary, the court declined to impose the requirement. The court stated that the separate subsidiary was a regulatory tool, not appropriate for an antitrust court to use. "A separate subsidiary does not eliminate economic incentives for anticompetitive conduct," the court observed, "it is simply a method of revealing intracompany transactions so that regulators

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[5] United States v. American Telephone and Telegraph Co., 552 F. Supp. 131 supra at 193.

may more effectively prevent cross-subsidization and other improper behavior." The court left the use of the separation to FCC.[6]

In the final settlement order the court restricts BOCs from providing "information services" which the court indicated are "essentially the equivalent" of the "enhanced services" that FCC described in its Computer II decision.[7] However, FCC, in its Notice of Proposed Rulemaking on possible requirement of separate subsidiaries for the BOCs' provision of CPE and enhanced services, states, "It is not clear that the scope of information service is congruent in all respects with our Computer II definition of enhanced services." FCC said that BOCs may interpret the consent decree as allowing them to provide certain enhanced services that may be included in the definition of "telecommunications" service, which is a permissible offering under the settlement. The Department of Justice, in its comments on FCC's notice, also recognized that the definition of permissible "exchange telecommunications and exchange access services" in the settlement may be broader than the current definition of "basic" services under Computer II. Thus, the Department of Justice concluded, BOCs may not be barred from offering "certain" enhanced services. The court describes two distinct types of "information services": those which involve no carrier control over the content of the information other than for transmission purposes and those in which the carrier would control both the transmission of the information and its content, such as news or entertainment, also called electronic publishing. The settlement prohibits AT&T from entering the latter market for 7 years after divestiture.[8]

## The separate subsidiary requirement and the AT&T affiliates

The settlement decree ending the antitrust action against AT&T has already had an impact on the application of the separate subsidiary requirement for unregulated activities to the Cincinnati Bell, Inc. (CBI), and Southern New England Telephone Company (SNET). In February of this year, FCC reversed an earlier decision and granted a waiver of the Computer II structural separation requirements for CBI and SNET because of the fundamental changes in the structure of the telecommunications industry resulting from the antitrust settlement.

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[6] United States v. American Telephone and Telegraph Co., 552 F. Supp. 131, 193 supra footnote 251.

[7] Ibid. 189 and footnote 198.

[8] Ibid. 187.

In a proceeding before the settlement, FCC had considered the waiver for CBI and SNET and in October 1981 found that the structural safeguards developed in the Computer II Inquiry should apply. Although the two affiliates are not majority owned by AT&T, FCC concluded that they were full partners in the Bell System and were indistinguishable from the then AT&T-owned BOCs.

With agreement by AT&T to divest the BOCs, CBI and SNET, however, no longer met the four standards (listed previously) for applying the Computer II requirement. AT&T's ownership interest in CBI and SNET was unaffected by the settlement, but the two companies' license contract[9] and standard supply contract arrangements with AT&T and Western Electric (the Bell System's manufacturing arm), respectively, must be terminated by the divestiture date. Although FCC found that the CBI and SNET local exchange monopolies will continue to be effectively controlled by AT&T after divestiture, neither company was found to be of sufficient size or sufficient regional market dominance to warrant the imposition of a separate subsidiary requirement for the provision of CPE and enhanced services. The FCC staff pointed out that a variety of safeguards, including FCC requirements for accounting, approval of regulated service tariff conditions, oversight by Federal and State commissions, vigorous surveillance, and the terminations of contracts with AT&T, will discourage anticompetitive conduct by CBI and SNET. (See table 1, page 8, for relative size of CBI and SNET.)

As indicated by the reversal in the CBI and SNET situation, FCC's approach to the separate subsidiary requirement for carriers' unregulated activities has continued to evolve over the period since the Computer I Inquiry was initiated in 1966 because of the increased use of computers in telecommunications services and other factors like the divestiture. An outline of the key decisions and how they applied to the major telephone carriers from Computer I through the current proceeding appears in table 2 on page 9.

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[9]See glossary.

Table 1

Relative Size of the Divested BOC Regions, AT&T Affiliates, and Largest Independent Telephone Companies[a]

| | Total network access lines[b] (000 omitted) |
|---|---|
| Midwest region BOCs | 13,930 |
| Mid-Atlantic region BOCs | 13,920[c] |
| Southeast region BOCs | 13,234 |
| Northeast region BOCs | 12,553 |
| Far West region BOCs | 10,725 |
| Mountains & Great Plains region BOCs | 10,376 |
| Southwestern region BOC | 10,124 |
| GTE Corporation (U.S. only) | 9,702 |
| United Telephone System, Inc. | 2,944 |
| Continental Telcom Inc. (U.S. only) | 2,090 |
| Southern New England Telephone Co.[d] | 1,536 |
| Centel Corporation | 1,177 |
| Mid-Continent Telephone Corporation | 698 |
| Cincinnati Bell Corporation[d] | 680 |
| Puerto Rico Telephone Co. | 477 |
| Rochester (N.Y) Telephone Co. | 430 |

[a]Based on figures derived for December 31, 1982.

[b]An access line is a single link between a customer and the telephone network. The number of such lines gives a measure of the relative size of the firm's "bottleneck" local exchange facilities.

[c]The access line figure included in the Mid-Atlantic Region total for the C&P Telephone Company of West Virginia is for January 31, 1983, because the yearend figure was unavailable.

[d]AT&T affiliates.

Sources: For BOCs and affiliates--The January 1983 Bell System Administrative Report No. 1, Sheet 2, Line 28; for the independents--U.S. Independent Telephone Association, "Independent Telephone Statistics, Volume 1" July 1983, page 8.

Table 2

The Evolving FCC Policy on Separate Subsidiaries for Carriers' Unregulated Activities[a]

| Decision | AT&T | Post Jan. 1, 1984 Bell operating companies | AT&T affiliates CBI/SNET | GTE | Other independent telephone companies |
|---|---|---|---|---|---|
| Computer I (1971) | Maximum separation required for data processing ventures | (b) | Maximum separation required for data processing ventures | Maximum separation required for data processing ventures | Maximum separation required except for carriers w/revenues under $1 million |
| Computer II (Apr. 1980)[c] | Separate subsidiary required for enhanced services and CPE | Same as AT&T | Separate subsidiary requirement not clearly applicable | Separate subsidiary required for enhanced and CPE | No separation required; only separate books of account |
| Computer II Reconsideration (Oct. 1980) Further Reconsideration (Oct. 1981) | Same as above | Same as AT&T | Separate subsidiary requirement made clear | Separate subsidiary requirement removed | Same as above |
| Computer II In re: CBI & SNET (Feb. 1983) | (b) | (b) | Separate subsidiary waived | (b) | (b) |
| Docket 83-115 In re: Bell Operating Companies | (b) | To be decided | (b) | (b) | (b) |

[a]The column at left lists FCC decisions that affected the separate subsidiary issue and at top are the telephone companies involved. For each is listed the effect, if any, of the decision on this requirement for the carriers' unregulated activity.

[b]Decision was not applicable to carrier(s).

[c]Computer II decision was made nearly 2 years before agreement on the antitrust settlement in January 1982, which will result in the separated BOCs after Jan. 1, 1984.



APPENDIX I

## Table 3

### The 22 BOC's Composing the Seven Independent Regional Holding Companies After January 1, 1984

| Regions | BOCs |
|---|---|
| Northeast | New England Telephone and Telegraph Company |
| | New York Telephone Company |
| Mid-Atlantic | New Jersey Bell Telephone Company |
| | Bell Telephone Company of Pennsylvania |
| | Diamond State Telephone Company |
| | C&P Telephone Company (District of Columbia) |
| | C&P Telephone Company of Maryland |
| | C&P Telephone Company of Virginia |
| | C&P Telephone Company of West Virginia |
| Southeast | Southern Bell Telephone and Telegraph Company |
| | South Central Bell Telephone Company |
| Midwest | Ohio Bell Telephone Company |
| | Michigan Bell Telephone Company |
| | Indiana Bell Telephone Company |
| | Wisconsin Telephone Company |
| | Illinois Bell Telephone Company |
| Mountains and Great Plains | Northwestern Bell Telephone Company |
| | Mountain States Telephone and Telegraph Company |
| | Pacific Northwest Bell Telephone Company |
| Southwestern | Southwestern Bell Telephone Company |
| Far West | Pacific Telephone and Telegraph Company |
| | Nevada Bell |

## FCC's CURRENT PROCEEDING ON STRUCTURAL SEPARATION AS A MEANS OF PREVENTING ANTICOMPETITIVE BEHAVIOR BY DIVESTED BOCs

In this appendix we will discuss the current FCC proceeding on whether to require the establishment of BOC separate subsidiaries by reviewing comments of interested parties and FCC views on the key factors in past decisions on structural separation. The antitrust settlement allows the divested BOCs to participate in some unregulated activities, which in turn creates the possibility that they may participate in some forms of anticompetitive behavior, such as cross-subsidy. The essential question in FCC's current proceeding is whether the BOCs, after divestiture, will possess an ability and incentive for anticompetitive behavior which will outweigh costs to the BOCs associated with their establishing and operating a separate subsidiary.

FCC's Notice of Proposed Rulemaking in Docket No. 83-115 asked two questions of commenters:

--Should a divested BOC be subject to a separate subsidiary requirement for the provision of enhanced services, CPE, and cellular communications[1] services?

--If structural separation is required, what separation requirements should govern the relationship between the subsidiary and the affiliated entities?

Many of the parties that filed comments in the proceeding stated that the incentives and opportunities for BOCs to be anticompetitive were sufficient to require structural separation. A variety of telecommunications interests and the Department of Justice took this general position. On the other hand, a few commenters--for example, AT&T, the National Telecommunications and Information Administration (the Government's telecommunications policy formulator, promoter, and coordinator in the Commerce Department), and the Department of Defense--argued that the circumstances did not call for separate subsidiaries because the divested BOCs no longer had enough incentive to be anticompetitive. The States commenting in the docket said that the imposition of separate subsidiaries on the BOCs should be left to them, rather than to FCC.

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[1]Cellular communications is a new form of mobile telephone service.

In its discussion of the separate subsidiary issue in the original Computer II order, FCC cited the primary benefit of the structural approach as

> "* * * protection for the regulated market ratepayer against costs transferred from the competitive market by the parent corporation, and protection for the general public against such anticompetitive activities as denial of access and predatory pricing." [Denial of access refers to possible carrier action to prevent connection of a potential customer to the telephone network; predatory pricing is the sale of equipment or service for less than cost to drive out competitors.]

Other advantages include promotion of equal access to local exchange facilities by all CPE and enhanced service providers in order that no provider has unfair advantage over competitors, and reduction of resources needed for monitoring of carriers--i.e., regulatory oversight is less costly when transactions between regulated and unregulated activities are made clear by the corporate separation of activities.

Despite these advantages, the separate subsidiary is not without its limitations. A separate subsidiary cannot in and of itself ensure the absence of anticompetitive behavior by carriers with market dominance because the requirement does not diminish the incentives of a firm to which it is applied. Consequently, the requirement clearly does not eliminate the need for regulatory scrutiny. Structural separation may also add to the carriers' costs of providing unregulated services because of the additional expense in establishing the separate organization.

Although the subsidiary requirement does not alter incentives, FCC has stated that it reduces the ability of dominant firms to engage in predation or to do so without detection. The principal mechanisms employed, according to FCC, are the reduction in the extent of common costs between affiliated firms; the requirement that transactions move from one set of corporate books to another; the publication of rates, terms, and conditions for services that will be available to all potential users, which is particularly useful where communications common carriers are concerned. Publication of rates, terms, and conditions assures that all users may receive service from the common carrier on the same basis--even when they compete with the common carrier to provide some unregulated services, such as a computer (enhanced) service.

In Computer II, FCC contended that accounting requirements could not substitute for structural separation; rather, it viewed such requirements as a "fundamental regulatory tool" utilized by FCC in its regulatory responsibilities. FCC stated that "When used in conjunction with the separate subsidiary concept, accounting serves as a useful regulatory tool for identifying certain abuses," and thus it viewed separation and accounting as part and parcel of a single regulatory mechanism. Carriers with market power and control over facilities essential for enhanced services could at a minimum distort the competitive market at the expense of the ratepayer through cross-subsidization and other anticompetitive behavior, FCC said. Where a carrier has the ability and incentive to engage in such behaviors, FCC said that accounting may identify, but cannot prevent, the misallocation of common costs when the same entity provides regulated and unregulated services. "On the other hand," FCC said, "the separation requirement serves as a structural check on the proper allocation of costs * * *." Therefore, even if the separate subsidiary requirement is applied, as it has been in the case of AT&T, the need continues for accounting systems to distinguish between the costs of regulated and unregulated activities.

## THE KEY FACTORS FOR DECIDING ON SEPARATE SUBSIDIARIES

Both FCC, in its February 17, 1983, Notice of Proposed Rulemaking on structural separation and the BOCs, and the responses of commenters addressed the usefulness of structural separation in preventing anticompetitive behavior. The comments centered around these key decision factors which FCC first identified in its Computer II decision (see app. I, p. 4): bottleneck facilities,[2] cross-subsidization, integration of operations, and resources required for separate subsidiaries. Some specifics on these factors and comments on them follow.

### Control over "bottleneck" facilities

FCC emphasized the importance of a carrier's control over bottleneck local telephone facilities as a determining factor in whether structural separation was needed to prevent the carrier from engaging in anticompetitive behavior. FCC also reiterated its belief that for a separate subsidiary requirement to be warranted, a carrier must control bottleneck facilities on a broad, national geographic basis.

After divestiture, the BOCs will be organized into seven separate regional companies, each of which will be the dominant provider of local exchange and exchange access service in its area, and will own a substantial amount of long-distance

[2]Bottleneck facilities refer to the monopoly local telephone exchange offices to which most customers are connected and through which most calls and services, whether basic or enhanced, must be switched.

facilities. A number of parties commenting on Docket 83-115 believed that the BOCs would possess sufficient control over local telephone facilities to warrant requirement of a separate subsidiary for the BOCs to compete in the unregulated markets for CPE, cellular communications service, and any enhanced services they are allowed under the antitrust settlement.

The Department of Justice emphasized the substantial competitive dangers posed by the BOCs' provision of complex CPE, given their control over the local exchange. It argued that if a competitor must purchase an essential service from the regulated firm (the local telephone company), poor quality connections to the telephone network or discriminatory pricing could be used to capture monopoly profits for the regulated firm's offering of CPE or enhanced services. The Department believed that problems could result from the BOCs' offering of complex CPE on a nonseparated basis, noting that such systems require a high degree of coordination between the equipment provider or customer and the local exchange carrier and that a BOC selling its own products (or those of a limited number of manufacturers) would have a strong incentive to coordinate less efficiently with unaffiliated CPE providers. On the other hand, the BOCs, in their reply comments, contended that developments in recent years demonstrate that the BOCs will no longer have extensive market power with respect to CPE after divestiture. They state that the Bell System's share of the market has fallen sharply for new complex and residential CPE.

Ability to cross-subsidize

The second key decision factor FCC has identified in determining the applicability of structural separation is ability to cross-subsidize. We noted in our prior report (CED-81-136) that where a firm operates in two markets--one monopoly and the other competitive--it has an incentive to cross-subsidize the competitive markets by undercharging for services in the competitive markets and overcharging for services in the captive monopoly markets. In the current proceeding on the BOCs, FCC stated that it believed effective cross-subsidization of entry into the CPE market requires a monopoly revenue base, which each of the divested BOCs would retain. FCC also noted that while there are few common equipment costs in the CPE and local exchange businesses, those costs do not exhaust the possible commonalities of the two lines of business. The BOCs would also have the opportunity to intermingle network-related and CPE-related costs of, for example, marketing, installation, maintenance, research, and development, as well as the central staff organization's general administrative management and other overhead costs.

In the notice, FCC also noted that, even if the potential for cross-subsidy existed, applying a separate subsidiary requirement may not be necessary if accounting systems were available to prevent cross-subsidization. FCC's efforts to develop such accounting systems are discussed in appendixes III and IV.

Integration of operations

The third factor affecting the BOCs' ability to be anticompetitive is the integrated nature of the carrier and their affiliates. In its Computer II decision, FCC expressed concerns about opportunities for cross-subsidization of unregulated activities. FCC said that when a firm providing regulated and unregulated products and services also conducts research, development, and manufacturing (termed vertical integration), it has an incentive to transfer costs for these functions from unregulated to regulated activities.

FCC stated that its concerns in this area regarding the BOCs were reduced by the divestiture agreement's prohibition on BOC manufacture of CPE and telecommunications equipment. On the other hand, FCC noted that the central staff organization (CSO), jointly funded and controlled by the BOCs, will participate in the product selection and purchasing process by providing the regional companies with technical evaluations of products or services and will also provide the procurement support functions. FCC noted that the extent of this centralized, procurement-related involvement in the purchase of network CPE may have an important impact on the independence of BOCs' individual procurement decisions. Further, the fact that the central staff will apparently perform research and development and product testing for both network equipment and CPE may result in concerns regarding how costs should be allocated between regulated and unregulated activities.

Some commenters in the docket, such as Rolm Corporation, a manufacturer of computerized telephone equipment and systems, claim that with the CSO's management structure, support functions and continuing relationship of the BOCs, the CSO will function as a monopoly buyer of equipment of all types and would be motivated to cross-subsidize--if structural separation is not imposed.

In the antitrust case, the court heard objections to the CSO in two major categories--contentions from consumer and regulatory interests that there was inadequate justification for an "overly large and costly organization," and claims by equipment suppliers that the CSO may, in effect, exercise control over many procurement decisions and favor Western Electric products. The court found that neither set of objections was sufficient to reject or modify the plan for the CSO.[3]

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[3]United States v. Western Electric, No. 82-0025 p. 134 (July 8, 1983).

Resources required for separate subsidiary

FCC's decision on whether to impose structural separation on a carrier involves a subjective weighing of benefits and costs. Both of these, FCC believes, are a function of firm and market size. In its Computer II decision, FCC decided that the costs of separation are borne disproportionately by smaller companies and that these additional costs may prevent them from competing in the enhanced services or CPE markets.

FCC and the BOCs, in commenting on Docket 83-115, pointed out that each BOC regional holding company will be as small as GTE--the largest of the independents. The Department of Justice noted that while GTE's overall corporation, including non-telephone exchange activities, is about equal in size to a regional holding company, the local telephone exchange business of each of the regional holding companies will be larger than that of GTE or any other independent. All of the independents are exempt from structural requirements.

The Department also contended that the costs of compliance with the separate subsidiary requirement are not high because the BOCs will be starting anew, organizationally, in unregulated business. The Department stated that no existing integrated organizational structure would have to be dismantled at significant cost to the companies.

# STATUS OF FCC's EFFORTS TO REVISE THE UNIFORM SYSTEM OF ACCOUNTS

The uniform system of accounts (USOA) FCC requires for domestic common carriers provides a means for classifying, recording, interpreting, and reporting a carrier's financial information. As such, it is a fundamental source of information for the regulator. FCC adopted the current USOA in 1935 when its basic concern was the overall financial results of the regulated firm. The USOA is broad and provides data for reviewing overall investment and expense levels, property valuation, and depreciation rates. The USOA has also provided a basis for reviewing carriers' overall revenue requirements, including the determination of a fair rate of return computed on an appropriate rate base.

Two events have served as a catalyst for revising the existing USOA. First, technological change has created new means of providing telecommunications services which are not reflected in the accounts. For example, current plant accounts do not reflect the use of microwave and satellite facilities for interchange communications. This same technological change has created a variety of new services not envisioned when the USOA was established. Second, in response to technological change, competitive entry has been allowed. This has created an incentive for cross-subsidy. Thus, FCC has been concerned with the costs (and rates) for individual services. Because it focuses on companywide results rather than individual services, the USOA has proved to be of little, if any, help in resolving issues regarding the appropriate rates for various services.

## Management problems hamper efforts to revise the USOA

In June 1978, FCC adopted a Notice of Proposed Rulemaking entitled "Revision of Accounts and Financial Reporting for Telephone Companies." The notice outlined a proposal for extensively revising the USOA for telephone companies.

In November 1979, we reported on the status of the USOA revisions. We identified a series of management problems which indicated that the revision might encounter difficulties in its implementation and use. In response to our report, FCC said that it would take a number of steps to improve management of the project. Nevertheless, on September 24, 1981, we reported that little progress had been made in revising the USOA and the project was in limbo. We reported that management problems continued to exist, including a lack of an individual with the responsibility and authority to direct the USOA revision and a lack of adequate attention by FCC. In addition, we reported that underlying the management problems was a fundamental debate over the general direction and structure of the revised USOA. The debate dealt with whether the revised USOA should restrict itself to financial accounting data or should also provide cost accounting data.[1]

FCC moves to deal with management problems

Beginning in October 1981, FCC renewed its efforts to revise the USOA by issuing a "Second Supplemental Notice of Proposed Rulemaking and Order." This order set forth FCC's objective in revising the USOA and provided a concept of how the system should be designed.

Since issuing this order, the FCC has taken the following actions to deal with past management problems:

--Established a Telecommunications Industry Advisory Group to develop, prepare, and submit a proposal for a basic framework and content of a revised USOA. The Group is meant to be a joint cooperative effort to assist in expediting the development of the revised USOA. The ultimate responsibility for the revised USOA, however, remains with FCC. The Advisory Group is made up of 10 distinct and separate interests which include FCC, AT&T, major independent telephone companies, small independent telephone companies, the American Institute of Certified Public Accountants, the National Association of Regulatory Utility Commissioners, large users of telephone services, equipment manufacturers, competitive communications common carriers, and the consuming public.

--Established a Steering Committee to provide overall direction for the project and six subcommittees responsible for various segments of the project.

--Assigned the Chief, Common Carrier Bureau, the authority to take all steps necessary to organize and manage the Group. The Chief, Accounting and Audits Division, has been given the day-to-day management responsibility for the project.

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[1]Financial accounting is defined as the accounting for revenues, expenses, assets, and liabilities that is commonly carried on in the general offices of a business. Cost accounting is that branch of accounting dealing with the classification, recording, allocation, summarization, and reporting of current and prospective costs. (A Dictionary for Accountants, by Eric Kohler, fifth edition, 1975.)

--Established a USOA staff within the Accounting and Audits Division of FCC's Common Carrier Bureau with responsibility to support the USOA project. The staff is comprised of five systems accountants. According to the Chief of the USOA staff, he receives additional technical support from engineers, attorneys, economists, and other specialists from the Bureau's staff as the need arises.

--Named one of the Commissioners as its supervising representative to oversee the USOA proceeding in a management capacity. This Commissioner has called the USOA revision FCC's single most important long-term proceeding.

Status of USOA revision

Generally, development of the USOA revision will involve seven phases prior to planned implementation by the carriers beginning on January 1, 1986. These phases are:

1. Startup activities, including issuing the Second Supplemental Notice setting forth the system design concept; establishing the Advisory Group and related committees and approving the membership; and deciding on various administrative matters such as adopting charters, by-laws, and reporting requirements.

2. Reports from the Advisory Group to FCC on each of four segments of the revision: plant accounts, expense accounts, revenue accounts, and remaining balance sheet accounts. The reports are to include the accounts, account definitions, and relevant accounting rules along with a brief narrative statement of the approach taken in designing the account structure. The plant accounts are to be completed first because of their critical importance to providing telephone service. The three account subcommittees are preparing these reports.

3. Upon receipt of the report on each segment, release of the report for comment by interested parties.

4. Analysis of the Advisory Group's report and the comments of interested parties on each of the four segments.

5. Issuance of a further notice of proposed rulemaking setting forth a complete, revised USOA for further comment.

6. Adoption by FCC of the final rules.

7. Implementation of the revised USOA by carriers.

As of the end of August 1983, work on phase one had been completed and an active committee structure and administrative framework had been established. Work on phase two was underway, and the account and other subcommittees had been working for 6 months or more to develop the necessary material for their reports. However, none of the reports had been completed. Current plans are for the first report on Plant Accounts to be submitted in September 1983. A tentative timetable existing in August 1982 envisioned the release of a Plant Accounts report by mid-1983, with additional report segments to be issued at 4- to 6-month intervals thereafter.

Cost accounting concerns continue

We observed in our September 1981 report that a fundamental debate was occurring among FCC's staff over the direction of the USOA revision. In our current review, we found that a similar debate continues among the membership of the Advisory Group's Steering Committee regarding how the USOA revision should handle cost and pricing considerations. In order to deal with these differences of opinion, the Steering Committee formed a Separation and Costing Subcommittee in April 1983 to develop recommendations for possible modifications of separations and costing/pricing procedures. It is too early to tell if this subcommittee will be able to adequately address costing matters.

Our September 1981 report stated that a fundamental debate had developed among FCC's staff over what should be the basic purpose of the USOA, that is, whether the USOA should restrict itself to financial data or should also provide cost accounting data. In January 1981, the Acting Chief of the Accounting and Audits Division suggested that the revised USOA should produce strictly financial data to which allocation procedures could then be applied to provide costing information. This suggestion prompted a sharp reply from Economics Division officials, pointing out that without cost accounting data FCC will not be in a position to (1) assess the justness and reasonableness of particular rate structures and rate levels, (2) prescribe rates, and (3) maintain proper surveillance over money and property flows which may be involved in cross-subsidization between services. The Chief of the Policy and Program Planning Division acknowledged the existence of this debate and stated frankly that there was no consensus on which way the project should go.

FCC attempted to resolve this debate in its Second Supplemental Order where it stated, "The revised USOA will be a financial accounting system." However, FCC did not ignore its regulatory needs for cost information. In the same order, it also stated:

"* * * We perceive the new USOA as a financial accounting system which will meet the financial and primary fiduciary reporting needs of the telephone industry and will provide the body of financial data to which appropriate methodologies can be applied to develop the requisite information to satisfy both our regulatory and management's data needs * * *."

Elsewhere, FCC reiterated this approach and further stated:

"* * * While our underlying concept of the USOA has evolved from a cost to a financial approach, it is still our express intention that those principles and objectives [to be accomplished in the USOA revision] be fully and completely adhered to and satisfied as a result of this proceeding. One of these principles was that the Commission's data needs for regulating a dynamic, competitive telecommunications industry be met. To achieve this, it is necessary that the Commission be able to obtain cost of service data. While service categories will not be incorporated in the financial accounting system, cost of service information will be developed by applying the separations and costing rules and procedures being developed in other dockets to the financial data contained in the revised USOA. In this way, we will not jeopardize the integrity or audit ability of the basic financial data, while ensuring that our regulatory needs are met * * *."

During the period from about September 1982 to April 1983, differences of opinion arose among members of the Advisory Group's Steering Committee regarding how, if at all, its work to revise the USOA should consider costing and pricing issues. Generally, some representatives believed that the Advisory Group should focus on developing a revised USOA which will provide financial information while questions of cost would be addressed in other current or future dockets. The other view maintained that the principal reason that the USOA requires revision is to make it responsive to FCC's costing and pricing responsibilities under the Communications Act. Therefore, the representatives believed that the USOA revision needs to give some consideration to costing issues, even recognizing that the USOA is meant to be a financial accounting system.

To help deal with this dispute, in April 1983, the Steering Committee established a Separations and Costing Subcommittee whose mission includes developing recommendations for additional data elements to support separations and costing procedures as well as possible modifications to these procedures. As of the end of July 1983, the subcommittee had held only three meetings. These meetings dealt with administrative and organizational matters and with discussions of current separations and costing procedures.

# FCC PROCEEDINGS TO DEVELOP COST ALLOCATION PROCEDURES TO ALLOCATE COSTS OF CARRIERS' REGULATED AND UNREGULATED ACTIVITIES

FCC has two active proceedings that are considering procedures for use by telephone companies in allocating costs between their regulated and unregulated activities. One proceeding (Docket 81-893) concerns accounting procedures for the independent telephone (non-AT&T) companies that must maintain separate books of accounts. The other proceeding (Computer II implementation) deals with the adequacy of procedures proposed by AT&T to allocate costs of shared services to its unregulated separate subsidiary. When these proceedings are completed and procedures prescribed, monitoring will be necessary to verify that carriers are implementing the procedures properly. FCC is seeking to obtain additional audit resources starting in fiscal year 1985.

## DOCKET NO. 81-893

In Docket No. 81-893, "Procedures for Implementing the Detariffing of Customer-Premises Equipment and Enhanced Services (Second Computer Inquiry)," FCC is addressing the appropriate accounting requirements for carriers that will be offering both regulated and unregulated services and that are not required by Computer II to set up a separate subsidiary for unregulated equipment and services. A Notice of Proposed Rulemaking was issued in this proceeding on June 21, 1983, with the final order expected to be issued later in the year. The Notice asks interested parties to comment on and suggest the appropriate accounts, allocation procedures, and controls necessary to ensure that the unregulated operation receives an appropriate amount of each company's costs. The procedures established will be effective 6 months after the issuance of the final order. Until that time, carriers may use any reasonable method to record accounting data for unregulated equipment and services separately from their regulated operations.

FCC also emphasized that the Computer II decision does not foreclose State authorities from establishing additional protections, such as structural separation requirements for independent telephone companies, for the benefit of State ratepayers. Where the FCC has not required separate subsidiaries, regulatory tools such as accounting requirements and structural separation are available to the States to meet their legitimate regulatory interests in ensuring that an intrastate carrier's participation in unregulated activities is not at the expense of the ratepayers for regulated services.

FCC REVIEW OF AT&T PROCEDURES

As discussed in appendix I, FCC did not impose total structural separation on AT&T. FCC rejected the idea of stringent, total separation of the subsidiary from other affiliated companies, stating that where there are efficiencies to be gained in shared services, the companies "should not be precluded from capitalizing on them where countervailing regulatory considerations do not demand stringent separation."

The development of appropriate accounting procedures to allocate the cost of shared services between AT&T's subsidiary and affiliated entities has proceeded under the direction of the Computer II Task Force, independently of the 81-893 proceeding. Basically, FCC's approach to ensure that accounting procedures are adequate is to have the Computer II Task Force review and approve procedures proposed by AT&T.

In Docket 83-115, FCC noted that the divested BOCs will have the opportunity to intermingle regulated and unregulated costs of administrative services and research and development. FCC's review of AT&T's proposed cost allocation procedures for these types of shared services identified concerns regarding (1) the use of revenues as a factor in allocating costs and (2) the amount of discretion given to managers as to how they assign costs. FCC and AT&T have been working to resolve these and other problems and develop acceptable procedures. FCC has conditionally approved these procedures; however, it is still reviewing whether they need further adjustments.

Concerns identified with AT&T procedures

To assist in its review of certain shared administrative services (for example, accounting, auditing, legal services, personnel recruitment and management, finance, tax, insurance and pension services), FCC has relied to some extent on the opinion of AT&T's independent auditing firm regarding the adequacy of AT&T's accounting procedures.

FCC's and the auditing firm's review raised similar concerns about AT&T's accounting procedures for shared administrative services. In January 1982, the auditing firm issued a report to AT&T which observed that although the systems were not yet fully designed, the costing methodology and accounting procedures described by AT&T appeared likely to result in an appropriate allocation of costs of shared services between the subsidiary and other AT&T affiliates. The report cautioned, however, that the impact of various methodologies should be monitored during the implementation phase to determine whether they are operating appropriately. Caution was expressed regarding employee compliance with time-reporting procedures, the degree to which

AT&T's procedures for establishing budget decision packages are established to directly allocate costs to individual companies, and whether the results achieved from use of overhead loading rates to distribute indirect costs and allocation of costs through use of the composite allocator are accurate.

Budget decision packages are associated with a budget process which requires AT&T managers to divide the activities of their individual sections into component parts. The process to create a specific package was important because under AT&T's proposed accounting proceeding packages unique to the subsidiary will be directly allocated to the subsidiary without the use of allocation factors. The FCC staff was concerned about the process to create these packages because the process is highly dependent on managerial discretion.

In November 1982, the auditing firm issued a followup report which addressed the concerns raised in its January 1982 report. The firm concluded:

> "In our opinion, for the quarter ended September 30, 1982, the System and the related costing methodologies and accounting procedures have provided for a reasonable and proper allocation of General Department costs between ABI [the separate subsidiary named American Bell, Inc.] and other affiliated entities of AT&T and that a material adjustment to the allocation of costs is not required. However, we did note certain areas where controls should be improved in order to enhance the effectiveness of the System and to provide further assurance, in the future, that a material error could not arise. These comments were brought to the attention of AT&T management and corrective procedures have been adopted."

FCC was also concerned with the allocation ratios AT&T proposed for calculating the subsidiary's share of the cost of shared administrative services where the subsidiary cannot be directly charged. AT&T intended to use a "composite allocator" comprised of the average which the proportions of assets, revenues, expenses, and employees of the subsidiary bear to all AT&T affiliates sharing each particular service. FCC's concern was that the inclusion of revenues in that allocator appeared likely to underallocate expenses to the subsidiary because the subsidiary's revenues would be small in the early years. FCC stated that the composite allocator should be revised to delete revenues as a factor until the first year after the year in which the subsidiary has reached a "mature state" as determined by FCC.

AT&T proposed that a portion of fundamental research and development also be allocated to its separate subsidiary using the composite allocator. FCC staff's concern was similar to their objection to the composite allocator's use for administrative services. The staff believed that a composite allocator based on revenues and expenses generated in the separate subsidiary's startup phase would be unlikely to allocate to the separate subsidiary its fair share of fundamental research expenditures.

Instead of a composite allocator, the FCC developed what it believed was a better method of ensuring a proper allocation of fundamental research and development and directed that AT&T use FCC's approach for a transitional period. FCC's approach identified two categories of CPE-related fundamental research that clearly involved work for CPE which will be sold only by the separate subsidiary. FCC concluded that the separate subsidiary's share of fundamental research should bear the same relationship to total fundamental research as the two CPE-related categories bear to the total research and systems engineering expenditures other than fundamental research.

## PLANNED FCC AUDITING OF BOCs

FCC's experience in reviewing AT&T's proposed allocation procedures suggests that when procedures are approved for AT&T and the other carriers, including the BOCs, continual monitoring will be necessary to verify that the procedures are implemented as approved and to reflect changes that result as the separate subsidiary matures.

FCC has a current staff of about 14 auditors who have generally been restricted to auditing AT&T locations in Washington, D.C., and New York City because of limited travel funds. In its proposed budget for fiscal year 1985, FCC's Common Carrier Bureau requested eight additional auditors and an additional $49,000 for audit-related travel. The Bureau, in justifying this request, stated:

> "With the breakup of AT&T and the recent Commission decisions that change the way carriers charge and account for telephone service, the Commission's current audit resources will clearly be inadequate to maintain the current level of auditing. The breakup of AT&T will produce seven new regional holding companies (RHC) that must now be audited. Further, the Commission has adopted several significant changes in the Separations Manual through which the telephone carriers assign their cost to the interstate jurisdiction. Also, through access charges, the Commission has significantly changed the way telephone carriers charge customers for these interstate costs. Finally, the Commission in the near future will adopt a

completely new acounting system for telephone carriers that will be used by all of the major telephone carriers. The carriers' implementation of all of these changes must be audited to ensure carrier compliance with the Commission's overall objectives.

"In prior audits of AT&T, the Commission, through its New York Field Office (NYFO), has audited only AT&T companies in the New York area (New York, New Jersey Long Lines General Dept.) and problems discovered at these companies were, in the vast majority of the cases, present in the other Bell operating companies (BOC). This was true because AT&T's General Department issued uniform procedures that were followed by all of the BOCs. With the breakup of AT&T the Commission will no longer be able to conduct audits at one BOC and assume that the audit findings will apply to the other BOCs. Therefore, the Commission must have additional resources to maintain its current level of auditing."

The Bureau's request was cut back to six auditors and $20,000 in travel funds by FCC's Managing Director, the administrative head of FCC, who believed that these increases can provide the required auditing support. These added resources would permit triennial audits of each of the seven regional holding companies. The Bureau's staff did point out to us that State regulators and competitors will provide some degree of oversight by bringing anticompetitive practices to the attention of FCC.

## COST ACCOUNTING STANDARDS AND INDEPENDENT AUDITORS' EVALUATIONS ARE POSSIBLE WAYS TO HELP ENSURE PROPER COST ALLOCATIONS

We identified two approaches which could assist FCC in monitoring carriers' implementation of cost allocation procedures to ensure that they are proper and do not burden the regulated ratepayer. These approaches are the adoption of cost accounting standards and evaluations by independent auditing firms that cost allocation procedures are proper.

### Cost accounting standards

The adoption of cost accounting standards (CASs) could assist the FCC in allocating costs between regulated and unregulated activities. Further, the application of CASs could increase FCC's assurance that the costs of unregulated activities are not borne by regulated service ratepayers.

The Cost Accounting Standards Board was an agency established by the Congress to promulgate cost accounting standards designed to achieve greater uniformity and consistency in the cost accounting practices followed by defense contractors. From about 1970 to 1980, the CASs Board promulgated 19 standards[1] covering virtually all aspects of cost accounting and grouped them in three categories: overall cost accounting matters; classes, categories, and elements of cost; and pools of indirect cost.

The first category of standards addressed overall cost accounting matters such as consistency in allocating costs incurred for the same purpose and consistency in estimating, accumulating, and reporting costs. The second category addressed particular elements of cost and was directed toward selected trouble spots in cost accounting, such as depreciation of tangible capital assets, composition and measurement of pension costs, accounting for insurance costs, capitalization of tangible assets, and cost of money. The third category addressed the problem of assigning indirect costs. These costs, not specifically associated with a particular contract, are "pooled" and allocated as a cost to all the contracts. Standards in this group included allocation of home office expenses and allocation of business unit and general administrative expenses to final cost objectives.

These standards are binding upon certain Federal agencies and upon contractors and subcontractors with national defense contracts. While the standards are required for national defense contracts, they are designed to address a cost accounting system where it is necessary to trace expenses to final cost objectives on a beneficial or causal relationship. CASs provide criteria for defining and measuring costs, the period to which such costs are assignable, and the methods by which costs are to be allocated to cost objectives. Consequently, we believe CASs could be equally applicable to telephone companies and could provide a consistent basis upon which to allocate cost of service among various telecommunications activities.

We believe that the major tasks to be undertaken as a part of FCC's Computer II decision could be accomplished to a large degree through the adoption of CASs. For example, FCC is to establish a system to ensure that the costs of any administrative service AT&T shares with its subsidiaries are allocated properly. CAS 403, "Allocation of Home Office Expenses to Segments," provides criteria for allocating these expenses based on the beneficial or causal relationship between such expenses and the receiving segments. The following table lists other selected Computer II tasks and the relevant standard which should be considered in accomplishing the task.

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[1]The Board's promulgations have all been incorporated in Title 4 ("Accounts") of the Code of Federal Regulations.

| Computer II task | Cost accounting standard |
|---|---|
| Review of subsidiary capitalization plans. | 404 (Capitalization of tangible assets) |
| | 409 (Depreciation of tangible capital assets) |
| | 414 (Cost of money as an element of the cost of facilities capital) |
| Develop a system to allocate installation and maintenance costs. | 403 (Allocation of home office expenses to segments) |
| | 410 (Allocation of business unit general and administrative expenses to final cost objectives) |
| | 418 (Allocation of direct and indirect costs) |
| Develop a system to ensure that research and development costs are properly allocated. | 420 (Accounting for independent research and development costs and bid and proposal costs) |

We believe that CASs are applicable in FCC's attempt to provide for the proper allocation of costs between regulated and unregulated telecommunications activities. Because CASs provide a sound basis for cost measurement and allocation, FCC should seriously consider their adoption.

## Evaluation by independent auditing firms

Without sufficient auditing FCC will need to rely to some extent on the carrier's statement that it is complying with prescribed accounting requirements; oversight by State regulators; and the self-interest of competitors to bring anticompetitive practices to FCC's attention. If FCC is unable to obtain the additional staff resources it has requested for fiscal year 1985 or if it later decides that the added staff is not sufficient, FCC should look at alternative approaches for carrying out the necessary monitoring. One way to help monitor compliance with the cost accounting standards and other accounting requirements is for FCC to consider the use of independent auditing firms or contractors to evaluate the adequacy of carriers' cost allocation procedures.

The Chief, Accounting and Audits Division, told us that he was concerned that if the carriers pay the auditing firms' fees, there could be a perception of a conflict of interest. He suggested as a modified version, that FCC hire the auditing firms and pay their fees with funds received from the carriers. The Chief, Common Carrier Bureau, told us that although evaluations by auditing firms or contractors was an option worth considering, it was likely to be costly. He also noted, however, that it would be difficult to estimate the cost of this approach.

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