ORIGINAL

BELLSOUTH TELECOMMUNICATIONS, INC.

REBUTTAL TESTIMONY OF G. DAVID CUNNINGHAM

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 990649-TP

JUNE 29, 2000

Q. PLEASE STATE YOUR NAME, ADDRESS AND POSITION WITH BELLSOUTH TELECOMMUNICATIONS, INC. (HEREINAFTER REFERRED TO AS "BELLSOUTH" OR "THE COMPANY").

A. My name is G. David Cunningham and my business address is 3535 Colonnade Parkway, Birmingham, Alabama 35243. My position is Director in the Finance Department of BellSouth.

Q. ARE YOU THE SAME G. DAVID CUNNINGHAM WHO FILED DIRECT TESTIMONY IN THIS DOCKET?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my testimony in this proceeding is to respond to the direct testimony of Michael J. Majoros, representing AT&T and MCI, the rebuttal testimony of William J. Barta, representing the FCTA, and the rebuttal testimony of Carol Bentley, representing Supra, regarding the appropriate economic lives for use in BellSouth's cost studies.

Q. IN THEIR TESTIMONIES, MR. MAJOROS (ON PAGE 4) AND MR. BARTA (ON PAGE 7) STATE THAT FORWARD-LOOKING LIVES SHOULD BE USED IN THE COST STUDIES. DO YOU AGREE?

A. Yes, I do. The asset lives used in BellSouth's cost studies were provided in Exhibit GDC-1 of my direct testimony. These lives are supported by BellSouth's 2000 Florida Depreciation Study, which was attached to my direct testimony as Exhibit GDC-2. The lives provided in Exhibit GDC-1 are forward-looking lives that appropriately reflect the impact of rapid technological changes taking place in the telecommunications industry.

Q. WHAT IS THE BASIS OF THE LIVES THAT MR. BARTA AND MR. MAJOROS RECOMMEND FOR USE IN BELLSOUTH'S COST STUDIES?

A. Mr. Barta recommends on page 8 of his testimony that the projection lives prescribed by the FCC for booking depreciation expense on an interstate basis be used in the cost studies. Mr. Majoros states on page 4 of his testimony that he recommends lives that are, with certain exceptions, consistent with the lives set forth in the Florida PSC's April

1998 UNE decision, as well as the FCC's 1995 prescription of BellSouth's interstate depreciation rates in Florida.

Q. DO YOU AGREE THAT LIVES RESULTING FROM THE 1998 UNE DECISION ARE APPROPRIATE?

A. No. Relying upon an agency decision rendered two years ago would be misguided because establishing economic lives for regulatory purposes can be a dynamic process. This is clear from the differences in the Commission's determination of lives in its April 1998 Order in Docket No. 960833-TP and the Commission's January 1999 Order in the Universal Service Docket, No. 980696-TP. For example, the January 1999 order reflected a life of 13 years for digital electronic switching equipment, while the April 1998 order showed 16 years. Also, the life ordered for digital circuit equipment was 8 years in January 1999, a change from 10.5 years in the April 1998 order. While BellSouth believes that the appropriate lives are those in Exhibit GDC-1 of my direct testimony, reverting to lives ordered two decisions ago is certainly an inappropriate step backwards.

Q. DO YOU AGREE THAT LIVES PRESCRIBED BY THE FCC ARE APPROPRIATE TO USE IN THIS PROCEEDING?

A. No. As I stated in my direct testimony in this proceeding, the lives currently prescribed by the FCC, particularly for the technology-sensitive accounts, are much too long. While Mr. Majoros and Mr. Barta opine that the projection lives prescribed by the FCC in the past are forward-looking, neither can seriously claim that the FCC has properly assessed the impact of technological evolution and increasing competition to determine appropriate forward-looking lives.

As I stated in my direct testimony, BellSouth currently establishes its own depreciation rates for intrastate purposes in Florida, under authority granted by Price Regulation implementation. However, when the Florida PSC did establish intrastate depreciation rates to be booked for BellSouth, they were considerably more progressive than the FCC in determination of appropriate asset lives for depreciation purposes.

BellSouth's Depreciation Study, provided as Exhibit GDC-2 in my direct testimony, provides detailed analysis to support forward-looking lives significantly lower than those prescribed by the FCC, particularly for the technology-sensitive accounts. Neither Mr. Majoros nor Mr. Barta has presented any studies of their own that would support use of FCC-prescribed lives in a forward-looking cost study.

Q. ON PAGE 7 OF HIS TESTIMONY, MR. MAJOROS REFERENCES A STREAMLINED, SIMPLIFIED DEPRECIATION RATE-SETTING PROCESS DEVELOPED BY THE FCC. HE GOES ON TO SAY THAT,

WITH THE SIMPLIFIED APPROACH, "THE FCC REAFFIRMED ITS FORWARD-LOOKING ORIENTATION". DO YOU AGREE?

A. No. The FCC's approach to simplification was to establish ranges of projection life and future net salvage estimates for most of the asset accounts. These ranges were developed by nothing more than taking one standard deviation around the mean of the lives and salvage values that the FCC had prescribed most recently for the various accounts for the local exchange carriers. When the FCC first ordered ranges, they were based on 1990-1992 represcriptions. (The FCC has made a change to only one account since ranges were established; that is, the low end of the range for the Digital Switching account was changed to 12 years.) Lives prescribed eight to ten years ago could hardly be considered forward-looking today.

Q. MR. MAJOROS (ON PAGE 8 OF HIS TESTIMONY) AND MR. BARTA (ON PAGE 9 OF HIS TESTIMONY) POINT TO AN INCREASE IN THE DEPRECIATION RESERVE OVER TIME AS EVIDENCE THAT FCC-PRESCRIBED LIVES HAVE BEEN FORWARD-LOOKING. DO YOU AGREE?

A. No. The fact that the reserve has grown over time is not an indication that the reserve is at the appropriate level. The critical issue here is not just that the reserve has increased over the past few decades. The issue is whether the reserve has increased enough to handle retirements that will occur because of the dramatic paradigm shift in the telecommunications industry.

It is interesting to compare the interstate reserve percentages for BellSouth quoted by Mr. Barta, in Exhibit WJB-3, page 1 of 4, with those included in Mr. Majoros's testimony in Exhibit MJM-5, page 1 of 2. Mr. Barta shows an end-of-year 1999 reserve percent for BellSouth's Florida operations of 67.25%, while Mr. Majoros shows 54.1% for the same timeframe. It appears that Mr. Barta has chosen reserve numbers that include items such as accrued liabilities and deferred credits. These items have nothing to do with accumulated depreciation associated with capital assets, and including them erroneously inflates the interstate accumulated depreciation reserve amount by as much as twenty percentage points. This error seems to have led Mr. Barta to the mistaken conclusion on page 10 of his testimony regarding FCC-prescribed lives, that "the economic lives of the plant in service have been shortened to reflect technological and/or market considerations".

Q. MR. MAJOROS PRESENTS HISTORICAL RETIREMENT RATES ON PAGE 11 OF HIS TESTIMONY TO OFFER "CONFIRMATION OF THE FORWARD-LOOKING UNBIASED NATURE OF CURRENT FCC PRESCRIPTIONS". MS. BENTLEY SIMILARLY ADVOCATES RELIANCE ON HISTORICAL DATA IN LIFE DETERMINATION ON PAGE 7 OF HER TESTIMONY. HOW DO YOU RESPOND?

A. Although they contend that the lives should be forward-looking, Mr. Majoros and Ms. Bentley focus on historical data, just as the FCC has done in prescribing BellSouth's depreciation lives. For example, Mr. Majoros admits on page 6 of his testimony that he uses this backward-looking approach to arrive at his recommended life of 25 years for fiber cable. Apparently, AT&T, on whose behalf Mr. Majoros is appearing, does not find that a 25-year life is fitting for its own fiber cable. AT&T's 1999 Annual Report to Shareholders states that "the useful lives of communications and network equipment range from three to 15 years." AT&T is not alone in this regard. For example, another ALEC operating in Florida, ITC DeltaCom, states in its 1999 Annual Report to Shareholders that its life for telecommunications equipment ranges from 5 to 20 years.

Mr. Majoros's rear-view mirror approach is clearly not appropriate for projecting the future of this equipment. BellSouth does not believe that simply looking at the past can possibly indicate what will happen in the future with equipment that is sensitive to rapid changes in technology. Emphasis on historical retirement patterns is an indication that one does not expect the future to vary significantly from the past. Even a casual observation of the telecommunications industry today leaves no doubt that there is an evolution taking place that cannot help but have a major effect on telecommunications assets.

Q. ON PAGE 18 OF HIS TESTIMONY, MR. MAJOROS CHALLENGES BELLSOUTH'S USE OF THE SUBSTITUTION ANALYSIS APPROACH FOR DETERMINING THE LIFE OF TECHNOLOGY-SENSITIVE ASSETS. WHAT IS YOUR REACTION TO HIS COMMENTS?

A. The substitution analysis technique used by BellSouth and recognized in technical depreciation literature has proven effective in projecting the adoption of new technologies and the obsolescence of old technologies, as stated in my direct testimony. This is a reliable method that has been developed and tested over many years in telecommunications and other industries.

On page 22 of his testimony, Mr. Majoros cites "tracking reports" included in BellSouth's 1996 Depreciation Study to support his claim that substitution analysis is not an accurate approach for determining life. The introduction to that study made clear that the "track record" information was provided to satisfy FCC study requirements and does not represent the dollar value of expected retirements. Comparing displaced units scaled to dollars with actual booked retirements is totally inappropriate.

Q. MR. MAJOROS STATES ON PAGE 20 THAT SUBSTITUTION ANALYSIS IS OF NO RELEVANCE IN DETERMINING THE LIFE FOR DIGITAL SWITCHING EQUIPMENT BECAUSE IT APPEARS THAT ASYNCHRONOUS TRANSFER MODE (ATM) SWITCHES WILL BE

DEPLOYED AS A SUPPLEMENT RATHER THAN A REPLACEMENT FOR DIGITAL SWITCHES. HOW DO YOU RESPOND?

A. BellSouth's 2000 Florida Depreciation Study (included as Exhibit GDC-2 with my direct testimony) does state that ATM switches are not currently seen as a direct replacement for digital switching. However, the depreciation study clearly describes digital switches as modular, with each module having its own life characteristics. Experience has shown that component modules of digital switches are regularly upgraded, rather than the switch being completely replaced, as was done in older switching technologies. Individual modules are replaced as required to satisfy the demand for new services or to eliminate equipment incompatibilities and capacity limitations.

An example of a digital switching modular component is the central processor and memory component. The evolution of processor technology continues to accelerate and is widely publicized. Much like Personal Computer processors and memory where a new generation becomes available about every six months, there is a new digital processor available approximately every two to three years from each major vendor.

The substitution analysis approach is appropriately used to study the life characteristics and to project the displacement of various components of digital switching equipment.

Q. MR. MAJOROS STATES ON PAGE 16 OF HIS TESTIMONY THAT COMPARING BELLSOUTH'S LIVES USED IN THE COST STUDIES TO THE LIVES LAST PRESCRIBED BY THE FCC FOR AT&T IS INAPPROPRIATE. DO YOU AGREE?

A. No. Much of the plant and equipment used to provide local and other telecommunications services by both AT&T and MCI WorldCom, on whose behalf Mr. Majoros is appearing, is identical to the plant and equipment used by BellSouth, or at least uses the same technology. Information available on the web sites of both AT&T and MCI WorldCom documents the use of plant and equipment such as fiber optic cable, digital switches, ATM switches, synchronous optical network (SONET) equipment, and Dense Wavelength Division Multiplexing (DWDM) equipment to provide services such as local voice and data, Digital Subscriber Line (DSL), Frame Relay, Internet Access and long distance – the same services offered by BellSouth, with the exception of long distance. Customer traffic carried by the networks of AT&T and MCI WorldCom is also carried by the networks of Local Exchange Carriers including BellSouth. Clearly, the economic value of assets owned by BellSouth, AT&T, MCI WorldCom, or any other ALEC is driven down similarly by technological obsolescence, increased competition, customer demand for new services and declining equipment prices.

One can in fact argue that there are factors that produce shorter life expectancies for BellSouth than for ALECs such as AT&T or MCI WorldCom. BellSouth's switches are more feature-rich because of the many services that are needed by end-user customers. As these services change and new services are developed, upgrades to both the software and hardware are necessary. These upgrades lead to replacement of components in the end-office switches. As AT&T and MCI WorldCom expand further into provision of local service, as they have publicly indicated they plan to do, these companies may find it appropriate to reduce their lives even further.

Q. MR. MAJOROS EXPRESSED CONCERN ON PAGE 19 OF HIS TESTIMONY REGARDING THE DEPLOYMENT OF NEW TECHNOLOGIES TO SUPPORT BROADBAND SERVICES. DO YOU HAVE COMMENTS REGARDING THESE CONCERNS?

A. Yes. Because of the capacity and reliability of fiber, it has been found to be the economic choice for interoffice (IOF) and feeder. Fiber in the distribution is economical for new developments as well as for normal rehabilitation projects, based only on maintenance savings and the revenues from services that could also be provided on copper. The addition of fiber in a network does not make it a broadband network, but fiber allows service providers to transport high traffic volumes, which may include higher bandwidth services.

Fiber has long been the economic choice in the IOF where the displacement of copper is essentially complete. In the feeder, fiber deployment is already at a significant penetration level. This, again, is due to the advantages of fiber's high capacity, low maintenance and reliability. Deployment of fiber in the distribution is also being driven by these advantages. Fiber deployment in the feeder has proceeded more rapidly than that in the distribution because traffic in the feeder can be aggregated and carried more efficiently in larger "pipes". Increasingly, the economics of fiber deployment make it desirable further and further out in the network (closer and closer to the customer premises).

It should be pointed out that many customers use modems that operate at up to 53,000 bits per second over narrowband, voice grade facilities. However, customer needs are expanding, and BellSouth is designing today's network so that it will provide the basis for meeting customers' growing needs. Today's customers are requesting services that require higher bandwidth such as high-speed internet access. Replacement of today's network will occur due to normal mortality and technological obsolescence, that is, when the current technology is not the most efficient means of providing voice and data services.

Q. IS THERE ANY MERIT TO THE CONCERN RAISED BY MR. MAJOROS ON PAGE 15 OF HIS TESTIMONY THAT LIVES USED FOR EXTERNAL REPORTING PURPOSES ARE INAPPROPRIATE

FOR USE IN THESE STUDIES DUE TO THE "CONSERVATISM" PRINCIPLE OF GAAP?

A. No. The "conservatism" principle of GAAP does not determine BellSouth's lives. BellSouth's economic lives, used for intrastate and external reporting purposes and in BellSouth's cost studies, are determined by the approaches described in this testimony and detailed in Exhibit GDC-2 to my direct testimony. These lives are used to determine depreciation rates that appropriately allocate the cost of BellSouth's assets over their estimated useful lives in a systematic and rational manner.

Arthur Andersen addressed the concern raised by Mr. Majoros about GAAP conservatism in a position paper filed with the FCC, which is attached to my testimony as Exhibit GDC-5. ("Supplement to July 15, 1998 Position Paper 'Accounting Simplification in the Telecommunications Industry'", prepared by Arthur Andersen LLP, November 10, 1998.) They stated:

> "The implication here is that conservative accounting principles would be the rule under GAAP, thus leading to understatements of net income and corresponding overstatements of costs and associated rates charged to ratepayers.

[This] interpretation of GAAP is misguided. The purpose of GAAP is to guard against material misstatements, including overstatements as well as understatements, in the financial statements. Financial statements prepared in accordance with GAAP are intended to present fairly, in all material respects, the financial position, results of operations and cash flows of the company. This 'presents fairly' concept covers both the understatement and overstatement of financial results. Thus, both shareholders and ratepayers are protected via the effective application of GAAP. If GAAP were purely based on conservatism ... then the auditors' report would state that the financial statements present conservatively, not fairly, the company's financial results.

[This view of GAAP] also ignores the reality of today's economic environment.... All companies, including the ILECs, face significant expectations by the investment community to meet or exceed earnings and earnings per share targets. To the extent that earnings fall below analyst expectations, the company's stock price and its ability to attract additional capital suffers. [The] assertion that

004194

conservative accounting would be applied in all cases in order to produce excessive regulated rates is ludicrous."

Q. ON PAGE 4 OF HER TESTIMONY, MS. BENTLEY ACCUSES THE ILECS OF USING "NON-STANDARD ACCOUNTING METHODS" WITH REGARD TO DEPRECIATION. HOW DO YOU RESPOND TO HER STATEMENTS?

A. BellSouth has in no way used, or advocated using, "non-standard accounting methods" with regard to depreciation. Rather, BellSouth relies, as Ms. Bentley suggests as appropriate on page 5 of her testimony, "standard accounting practices as embodied by the Generally Accepted Accounting Principals (sic)".

Q. HOW DO YOU RESPOND TO MS. BENTLEY'S SUGGESTION ON PAGE 6 THAT FUTURE TELECOMMUNICATIONS EQUIPMENT WILL SIMPLY REQUIRE SOFTWARE CHANGES RATHER THAN EQUIPMENT CHANGES, AND THEREFORE WILL NOT IMPACT THE EQUIPMENT'S LIFE?

A. Clearly, the majority of telecommunications plant and equipment in service (e.g., poles, cable, conduit, etc.) does not utilize software, and therefore would not be impacted by software changes. BellSouth assumes that Ms. Bentley is referring to switching equipment in her comments. Switching equipment has been moving in the direction of being software-oriented since the advent of Stored Program Control switches (i.e., analog electronic switching). However, to suggest that only software updates and no equipment changes will be needed would be like saying that no new Personal Computer hardware will be needed in the future but only new versions of the software. As microprocessors and memory chips have become common place in telecommunications equipment, software has certainly played a larger role in managing the network and developing new services. However, this trend has not slowed the obsolescence of equipment but rather accelerated it. The use of software to increase the capabilities of telecommunications equipment has broadened the range of services available to customers and increased efficiencies. As the demand for new and improved services has increased, it has driven the need for more memory and faster processors. Changes to peripheral equipment have also been necessary to accommodate new capabilities.

The use of software to develop and implement services will increase in the future. However, this trend will drive continued, if not greater, obsolescence of telecommunications equipment.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. Although Mr. Majoros, Mr. Barta and Ms. Bentley offer absolutely no analysis of their own for determining appropriate economic lives for use in BellSouth's cost studies, they argue that BellSouth's lives are wrong. The lives provided in my direct testimony in this proceeding in Exhibit GDC-1 were developed by performing detailed analyses of each asset account. These lives are comparable to lives used by other companies providing telecommunications services in Florida. They are appropriate for use in a forward-looking cost study, as opposed to lives established in the past.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

SUPPLEMENT TO JULY 15, 1998 POSITION PAPER

"ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY"

Prepared by Arthur Andersen LLP

November 10, 1998

ARTHUR ANDERSEN

ARTHUR ANDERSEN LLP
SUPPLEMENT TO JULY 15, 1998 POSITION PAPER
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

NOVEMBER 10, 1998

TABLE OF CONTENTS

ARTHUR ANDERSEN LLP
SUPPLEMENT TO JULY 15, 1998 POSITION PAPER
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

NOVEMBER 10, 1998

I. EXECUTIVE SUMMARY

In the Arthur Andersen LLP position paper titled "Accounting Simplification in the Telecommunications Industry," filed with the Federal Communications Commission ("FCC" or "Commission") on July 15, 1998 (the "Andersen Paper"), we discussed recommendations that can be implemented today to streamline and simplify the accounting and reporting requirements for all ILECs to facilitate the industry's move to a competitive, deregulated environment.

Our long-term recommendation is that all incumbent local exchange carriers ("ILECs"), consistent with other companies within and outside of the telecommunications industry, be allowed to adopt accounting and reporting practices in accordance with generally accepted accounting principles ("GAAP"). We recognize, however, that the long-term goal of GAAP accounting for all ILECs is just that -- a long-term objective. Thus, the Andersen Paper and this Supplement focus on recommendations to guide the transition from the current Class A accounting requirements ultimately to GAAP.

Arthur Andersen believes that the proposals for simplification and/or elimination discussed in the Andersen Paper and this Supplement should be adopted expeditiously by the Commission. They provide a framework for a ***transition*** from today's detailed Part 32 regulatory accounting and recordkeeping requirements to a "level playing field" where all carriers are subject to the same requirements under GAAP. Furthermore, the proposed recommendations do not compromise the FCC's or State Regulatory Commissions' statutory or mandated oversight or enforcement responsibilities. Significant transitional recommendations (areas of greatest opportunity) include:

- Adoption of Class B accounting and reporting practices for all ILECs;
- Reduction of detailed subsidiary recordkeeping requirements, including the expense matrix, where detail requirements exceed management information needs;
- Reduction of detailed property record requirements, redefinition of property units and implementation of expense limits related to network assets where appropriate;
- Simplification of depreciation practices and implementation of GAAP depreciation methods and lives for regulatory purposes consistent with many State Commission practices; and
- Simplification and eventual elimination of detailed affiliate transaction requirements, specifically those related to the performance of fair market value ("FMV") studies.

In this Supplement we also assess the current costs of compliance with the Class A accounting and reporting rules. Our analysis focuses on costs at certain large ILECs that could be redeployed and/or reduced should the ILECs adopt the short-term recommendations contained in the Andersen Paper and ultimately implement full GAAP accounting and reporting. The result of our analysis shows that the average compliance cost is approximately $45 million per ILEC, or about $270 million in total for the five RBOCs and GTE. This cost of compliance is clearly significant.

Finally, this paper addresses the reply comments of several parties to the above proceedings, in particular the Snavely King Report. We specifically address the numerous misstatements contained in the Snavely King Report as well as Snavely King's misinterpretations of the Andersen Paper, GAAP, the purpose of Part 32 and continued need for Class A detailed accounting and recordkeeping requirements.

Our short-term recommendations provide a reasoned, well-balanced approach to accounting simplification that will serve regulators and the industry well. These proposals, which upon examination are truly modest in scope, will not lessen the ability of the FCC and State Regulatory Commissions to enforce their Rules and the mandates of the Telecommunications Act of 1996 ("Telecommunications Act"). They will, however, provide the largest ILECs with added flexibility and significant savings and an opportunity to redeploy millions in cost savings to activities that benefit customers and advance the competitive telecommunications environment. Ultimately, these transition steps should lead to full GAAP accounting and reporting for all ILECs.

ARTHUR ANDERSEN LLP
SUPPLEMENT TO JULY 15, 1998 POSITION PAPER
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

NOVEMBER 10, 1998

II. INTRODUCTION

The purpose of this Supplement is to:

- Discuss in greater detail the recommendations contained in the Andersen Paper, particularly those areas of greatest opportunity, such as moving to a Class B account structure, that would provide for an effective and efficient transition from the current Class A Uniform System of Accounts ("USOA")[1] to the long-term goal of GAAP for all telecommunications carriers;

- Present the findings from our additional analyses of potential cost savings to be realized by certain large ILECs from adopting the recommendations contained in the Andersen Paper; and

- Respond to reply comments filed by several parties to the above proceedings, in particular the "Report of Andersen Position Paper" prepared by Snavely King Majoros O'Connor & Lee, Inc. (the "Snavely King Report").

III. SUMMARY OF RECOMMENDATIONS

In the Andersen Paper, we discussed recommendations that *can be implemented today* to begin the transition process to streamline and simplify the accounting and reporting requirements for all ILECs to facilitate the industry's move to a competitive, deregulated environment. These short-term recommendations provide a reasoned, well-balanced approach to accounting simplification that will serve regulators and the industry well. These proposals, which upon examination are truly modest in scope, include:

Part 32 Account Structure and Accounting Requirements

- Reduce current level of accounting detail for **all** carriers:
  - Rely on Class B level of reporting and eliminate the prescribed Class A main account and subsidiary account detail
  - Reduce or eliminate the subsidiary record categories for various cost types

- Eliminate expense matrix categorization requirements.

- Rely on GAAP principles of materiality rather than the current standards prescribed in the USOA.

[1] 47 C.F.R. § 32 et seq. (1997).

ARTHUR ANDERSEN LLP
SUPPLEMENT TO JULY 15, 1998 POSITION PAPER
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

NOVEMBER 10, 1998

- Rely on GAAP standards in lieu of the current USOA advance notification requirements related to:
  - Adoption of new accounting standards.
  - Recognition of extraordinary items, prior period adjustments and contingencies.

Property Records and Depreciation Requirements

- Reduce recordkeeping requirements and redefine property units to allow for the accounting and tracking of telecommunications plant assets at the level of detail used by management to run its business and manage its assets.
  - Eliminate notification requirements with respect to basic property record ("BPR") plan changes
  - Eliminate detailed plant subaccounts/subsidiary record categories which exceed GAAP and asset management requirements
  - Allow for the tracking of assets on an average cost, instead of original cost, basis
  - Reduce requirements for asset tracking - continue to require asset tracking by general location (address)

- Allow carriers to set depreciation rates and methods based on economic analyses in place of the current depreciation represcription and rate setting processes.

- Rely on GAAP principles of materiality in regards to capitalization policy, or begin the transition process by replacing the zero dollar limit with respect to network assets with agreed-upon limits.

- Allow for increased flexibility (within GAAP criteria) in the determination of depreciation expense. Carriers should be able to use depreciation methods that most closely reflect the use (and decline in net realizable value) of assets. Methods such as vintage amortization life ("VAL") for non-network and immaterial network assets, that reduce the ongoing costs of asset tracking and accounting, should also be allowed.

Affiliate Transaction Rules

- Implement a materiality-based and/or rotational requirement for performing FMV studies in order to limit the costs of compliance.

- Expand the exemption provided in Paragraph 148 of the Accounting Safeguards Order (that allows nonregulated affiliates of the ILEC that *exist solely* to provide services to members of the affiliated group to price such services at cost) to:
  - Support services provided *to* affiliates that exist solely to provide services within the affiliated group
  - Specific product/service lines offered only to affiliates

- Eliminate the asymmetrical affiliate transaction rules with respect to the provision of <u>services</u> between regulated and nonregulated affiliates.

- Eliminate the application of the 50% threshold on a product-by-product and service-by-service basis, for determining the existence of a "substantial" third party market and the validity of using prevailing market prices for affiliate transactions.

A proposed transition plan to facilitate the implementation of the above recommendations with the ultimate long-term solution being adoption of full GAAP accounting and reporting practices is presented in Attachment 1 to this filing.

IV. AREAS OF GREATEST OPPORTUNITY

The areas described above provide the greatest opportunity to begin the accounting simplification process. Adopting the above recommendations would provide a blueprint for the transition from the current detailed Part 32 accounting and reporting requirements to an environment based solely on GAAP. Further, adoption of these recommendations now would <u>not</u> lessen the ability of the FCC and State Regulatory Commissions to enforce their Rules and the mandates of the Telecommunications Act. Ultimately, GAAP should be the standard applied to all ILECs.

The recommendations discussed above will not only provide the large ILECs much needed relief from the current costly detailed Class A recordkeeping and reporting requirements, but will still allow the FCC and State Regulatory Commissions to continue to fulfill their oversight and enforcement duties. A Class B account structure (for all carriers) is auditable and provides a solid foundation for subsequent phases of the regulatory accounting process, including Part 64 cost allocations, Part 36 jurisdictional separations, Part 69 access charge development, ARMIS and uniform reporting. This accounting environment is in place today, as the vast majority of ILECs at both the Federal and State levels today utilize Class B accounting and reporting. Clearly, the FCC believes that Class B accounting detail will continue to be effective in achieving its regulatory oversight ability, as the Commission has proposed to extend the application of the Class B structure to the mid-sized ILECs. [2]

Further relief from burdensome recordkeeping requirements, particularly in the property records area, would enable the ILECs to refocus resources away from detailed accounting, tracking, verification, reconciliation and retirement of low dollar value items where the cost of performing the above activities clearly exceeds the benefits derived from such activities. Instead, the ILECs' resources could be redirected towards activities that benefit customers, both end users and other carriers.

Adoption of acceptable expense limits for network assets and aggregation of property records at a more manageable level of detail would not compromise the ability of FCC and State Regulatory Commission staffs to enforce the Commissions' rules, including the non-discrimination and cross-subsidy prevention requirements of the Telecommunications Act. In fact, carrier compliance with such simplified rules will be more readily auditable and therefore more enforceable due to the elimination of capital accounting for thousands of small dollar items. Alignment of property records with the level of detail used day-in-day-out by management to run its business and manage its assets would in itself be a control factor and would facilitate a well-controlled and auditable environment, as management is familiar, and more importantly, held responsible for asset performance at that level.

Finally, simplification of the affiliate transaction rules is needed. The Commission's Part 64 Rules have proven effective over time in preventing cross-subsidy on a fully distributed cost basis. The additional asymmetrical requirements for services provided amongst affiliates have added costs to this process without any demonstrated benefits. The prevention of cross-subsidy, as it had been from 1988 through mid-1997, can be accomplished absent the complicated task of determining a fair market value for services provided to affiliates. Immediate consideration should be given to relying on fully distributed cost not only for those companies that provide services solely to affiliated companies, but also for all services largely provided within the affiliated group. At a minimum, some reasonable materiality-based relief should be provided to eliminate the necessity of determining fair market values for de minimis services provided between affiliates.

V. ANALYSIS OF COSTS OF USOA COMPLIANCE

In order to expand upon our analyses presented in the Andersen Paper, we performed a detailed analysis of the costs incurred today by certain of the large ILECs, namely, Ameritech Corporation, GTE, SBC Communications Inc. and U S WEST, Inc. (the "Coalition ILECs") to

[2] *In the Matter of 1998 Biennial Regulatory Review – Review of Accounting and Cost Allocation Requirements,* CC Docket No. 98-81, Notice of Proposed Rulemaking, [hereinafter Accounting Simplification NPRM].

comply with the current Class A accounting and reporting requirements of the USOA. This analysis presents a more comprehensive picture of the cost savings that could be realized by the above ILECs by adopting the above transitional recommendations and moving to a streamlined Class B accounting and reporting environment and ultimately moving to an accounting and reporting environment solely based on GAAP.

The cost data presented in the Andersen Paper[3] was intended to provide a benchmark for comparison of the costs incurred by the ILECs in specifically-defined accounting and recordkeeping areas with costs incurred in those same areas by other capital-intensive companies of similar size operating in industries outside of the regulated telecommunications industry. The comparative cost data was intended merely to ***illustrate*** the resource and cost impacts to the large ILECs of having to comply with the current Class A accounting and reporting requirements in specific areas (with specific sections of the Part 32 rules). The tables in the Andersen Paper looked solely at employee-related costs in the areas of general accounting, property and depreciation accounting and affiliate transaction accounting. The tables ***were not*** intended to represent the ILECs' total costs of regulation or total costs of Part 32 compliance.

Summary and Overview of Analysis

The purpose of our additional analysis, therefore, was to expand on the above illustrations in order to capture a more comprehensive picture of the current costs of USOA compliance. Specifically, we accumulated data from the Coalition ILECs representing the resources (full-time equivalent employees) and costs that could be redeployed and/or reduced should the Coalition ILECs:

- Adopt the short-term recommendations contained in the Andersen Paper, specifically the reduced level of detailed accounting and reporting pursuant to the USOA Class B rules
- Ultimately implement full GAAP accounting and reporting

Our analysis involved the following primary procedures:

- Develop a survey and spreadsheet to facilitate ILEC data collection efforts with respect to the potential cost savings (consisting of salaries and wages, loadings and benefits, information systems and other costs) which could be realized should the Commission adopt the near-term recommendations in the Andersen Paper as well as full GAAP.
- Review and analyze the ILEC data to ensure the completeness, consistency and reasonableness of reported data.

[3] Andersen Paper, pp. 21, 33 and 45.

- Document key assumptions underlying the data reported and summarize and report the results.

Cost Savings Opportunities

Our analysis shows that, on average, the Coalition ILECs could realize average incremental cost efficiencies of approximately $20 million annually per ILEC with the adoption of GAAP in lieu of the current USOA Class A accounting and reporting requirements. Adoption of Class B accounting and reporting would result in approximately 10% of the above savings. The results of our analysis are presented below (dollars in millions):

AVERAGE INDIVIDUAL ILEC COST SAVINGS

Cost Savings Category	Amount
General Accounting	$ 2.9
Regulatory Accounting/Part 64 Compliance	2.9
Simplified Time Reporting Practices	5.7
Property Record Simplification	4.9
Adoption of Expense Limits for Network Assets	0.3
Simplified Depreciation Expense Practices and Methods	0.4
Reduced Affiliate Transaction Requirements	2.7
	$19.8

Summary of Key Cost Savings Assumptions:

1. Cost savings opportunities include costs related to salaries and wages, loadings, information systems and other costs. Annual full-time equivalent employee salaries and wages were computed at average wage rates ranging from $60,000 to $80,000, with loadings determined at 31-35% of wages and salaries.
2. Under full GAAP accounting, the following accounting and compliance functions are assumed to be eliminated or significantly reduced in scope:
   a. Account reconciliations, jurisdictional difference accounting and disparate jurisdictional reporting, and accounting systems costs would be significantly reduced.
   b. Regulatory accounting and Part 64 cost allocation accounting and compliance (and related audit costs) would be significantly reduced. Cost allocation process would occur at a less detailed level.
   c. Affiliate transactions accounting and compliance would be reduced, with transfer pricing of affiliate transactions determined at fully distributed cost.
   d. Elimination of depreciation mortality studies.

ARTHUR ANDERSEN LLP
SUPPLEMENT TO JULY 15, 1998 POSITION PAPER
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

NOVEMBER 10, 1998

3. The following critical assumptions relate to the simplification of property record requirements:
   a. Simplification and potential elimination of the current DCPR system.
   b. Adoption of simplified time reporting methods for central office and outside plant field technicians (including but not limited to statistical sampling methods).
   c. Adoption of reasonable expense limits for network assets in place of the zero dollar limit currently prescribed under the USOA.

Additional Cost Savings Implications

A significant cost to the Coalition ILECs that has not been considered in the cost savings above is the cost related to building Part 32 compliance into the purchase and implementation of packaged system software. The Coalition ILECs have either recently implemented new packaged general ledger and related feeder systems (such as accounts payable, accounts receivable and fixed assets) or have investigated implementing such software packages. Implementation of packaged software is driven primarily by efforts to obtain efficiency savings in the accounting and reporting process as well as the desire to obtain meaningful management information on a routine basis.

However, the ILECs have experienced significant levels of effort to ensure that Part 32 compliance was maintained in the new systems. The additional costs associated with maintaining Part 32 compliance when converting to packaged systems is substantial due to the amount of customization required to enable the new systems to capture and report regulatory information according to Part 32. Typically, "mappings" must be developed to get from the native accounts of the packaged system to Part 32 accounts, creating substantial programming and system modification costs for the ILECs. The on-going functionality of new systems is often severely diminished due to the level of records and data that must be added in order to comply with Part 32; systems simply cannot function as they were intended because of the large volume of data that is required under Part 32. The consensus of the Coalition ILECs is that approximately 25% of *total* general ledger system implementation costs can be attributed *exclusively* to customizing the system for Part 32, representing a large cost to the company. The ILECs further note that processing time is effectively *doubled* because of the level of information required by Part 32. These costs, on average, approximate $25 million in a typical $100 million packaged software systems implementation.

By any measure, the costs of USOA Class A compliance as summarized above are significant. While certain reply comments to the Andersen Paper discuss the "cost of regulation" in relation to total ILEC revenues, it should be noted that any one cost is relatively insignificant in comparison to total revenues. However, an average cost of $20 million per Coalition ILEC, or approximately $45 million when considering systems software implementation costs as described above, is significant. This means that collectively the large ILECs are spending in excess of $270 million in additional costs to implement and maintain a regulatory accounting system. This is money that can be gained in accounting and reporting efficiencies and redeployed into other areas that benefit customers and advance competition in telecommunications.

VI. RESPONSE TO REPLY COMMENTS

Finally, in this section, we respond to the comments contained in the Snavely King Report filed in the above proceeding. The Snavely King Report, prepared at the request of MCI Telecommunications Corporation ("MCI"), proposes that the Commission ignore the significant changes in today's telecommunications industry environment and impose more, not less, regulation in spite of the deregulatory and competitive mandates contained in the Telecommunications Act.

In particular, the Snavely King Report contains numerous misstatements of positions contained in the Andersen Paper with respect to both literal contents and context. For purposes of clarity, these misstatements are detailed in Attachment 2 to this report, along with clarifications of the Arthur Andersen positions with respect to each area of misstatement.

Purpose of the Part 32 USOA

In its report, Snavely King states that "The sole purpose of the USOA is for regulation. If it has other uses, they are an added benefit, but if there are no such other uses, that is irrelevant."[4] Further, Snavely King asserts that "A USOA that fully serves both regulatory and management accounting objectives is therefore impossible."[5] To the contrary, a truly effective chart of accounts has, as its underlying driver, meaningful management information that can be summarized and reported in accordance with GAAP for external reporting purposes and in accordance with regulatory guidelines for Federal and State regulatory reporting purposes. As summarized in the Andersen Paper, a more flexible chart of accounts that is closely aligned with GAAP can best accomplish this "best practice."

Adoption of the Class B Chart of Accounts for all ILECs would serve as a positive interim step to full GAAP accounting by allowing the ILECs greater flexibility within the chart of accounts and a resultant opportunity to generate more meaningful management information within such a structure. Elimination of the expense matrix and the advance notification requirements contained in Part 32 would further reduce the burden and cost of information that can still be obtained via other systems and methods. All the essential information necessary to carry out

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[4] Snavely King Report, p. 5.
[5] Id.

subsequent regulatory accounting processes, including Part 64 common cost allocations, Part 36 jurisdictional separations and the Part 69 access charge and other rate development processes would remain and be available for review.

Purpose of GAAP - To Fairly Present Financial Results

Snavely King states that "the basic purpose of GAAP is to protect investors, not ratepayers."[6] Snavely King further asserts that the GAAP principle of conservatism would lead to misstatements in financial results that would be a detriment to the ratepayer. The implication here is that conservative accounting principles would be the rule under GAAP, thus leading to understatements of net income and corresponding overstatements of costs and associated rates charged to ratepayers.

Again, Snavely King's interpretation of GAAP is misguided.[7] The purpose of GAAP is to guard against material misstatements, including overstatements as well as understatements, in the financial statements. Financial statements prepared in accordance with GAAP are intended to present **fairly**, in all material respects, the financial position, results of operations and cash flows of the company. This "presents fairly" concept covers both the understatement and overstatement of financial results. Thus, both shareholders and ratepayers are protected via the effective application of GAAP. If GAAP were purely based on conservatism as Snavely King asserts, then the auditors' report would state that the financial statements present conservatively, not fairly, the company's financial results.

Snavely King also ignores the reality of today's economic environment in its comments. All companies, including the ILECs, face significant expectations by the investment community to meet or exceed earnings and earnings per share targets. To the extent that earnings fall below analyst expectations, the company's stock price and its ability to attract additional capital suffers. Snavely King's assertion that conservative accounting would be applied in all cases in order to produce excessive regulated rates is ludicrous. This conclusion may be a result of the fact that Snavely King does not maintain as its primary function the audit and certification of financial statements as do public accounting firms, such as Arthur Andersen. In the rare cases when alternative accounting principles are acceptable, management's incentive is usually not to reduce reported income but to reflect the company's results in the most favorable light allowed pursuant to GAAP.

Finally, there are many guiding principles other than conservatism alone that support GAAP. As described in the Financial Accounting Standards Board's ("FASB") Statement of Financial

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[6] Snavely King Report, p.9.

[7] See also, Comments of GSA filed on August 3, 1998 in the Accounting Simplification NPRM.

Accounting Concepts No. 2,[8] the following are critical characteristics of accounting information presented in accordance with GAAP:

- *Relevance* - the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of the past, present and future events or to confirm or correct prior expectations.
  - *Timeliness* - having information available to decision-makers before it loses its capacity to influence decisions.
  - *Predictive Value* - information should be useful to present and potential investors, creditors and other users in making rational investment, credit and similar decisions and in assessing future cash flows.
- *Reliability* - the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent.
  - *Completeness* - the inclusion in reported information of everything material that is necessary to ensure that it validly represents the underlying events and conditions.
  - *Verifiability* - the degree of assurance that accounting measures represent what they purport to represent.
  - *Conservatism* - a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered.
- *Neutrality* - absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior.
- *Comparability* - enables users to identify similarities in and differences between an enterprise's reported information and similar information reported by other enterprises as well as information about the same enterprise reported for some other period or point in time.
- *Consistency* - conformity from period to period with unchanging policies and procedures.
- *Materiality* - the magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.
- *Costs and Benefits* - the information provided by financial reporting involves a cost to provide and use, and generally the benefits of information provided should be expected to at least equal the cost involved.

Obviously, the above attributes collectively serve to protect all users of financial statements prepared in accordance with GAAP. These users not only include shareholders, but regulators,

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[8] Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information" [hereinafter SFAC No. 2].

ratepayers, financial analysts and creditors, among others. Snavely King has focused on but one of the many guiding principles of GAAP.

Finally, SFAC No. 2, in its discussion of conservatism, has the following insight regarding conservatism that is particularly relevant in evaluating Snavely King's erroneous assertion that the principle of conservatism would harm ratepayers:

> "Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board [FASB] emphasizes that point because conservatism has long been identified with the idea that deliberate understatement is a virtue. That notion became deeply ingrained and is still in evidence despite efforts over the past 40 years to change it. The convention of conservatism, which was once commonly expressed in the admonition to "anticipate no profits but anticipate all losses," developed during a time when balance sheets were considered the primary (and often only) financial statement, and details of profits or other operating results were rarely provided outside business enterprises. The Board emphasizes that any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run. That kind of reporting, however well-intentioned, is not consistent with the desirable characteristics described in this Statement." [9]

It is ironic that Snavely King terms certain of the recommendations in the Andersen Paper (see "Depreciation Rates and Practices" section below) "way out of date" in light of their obvious dated use of the convention of conservatism as described in SFAC No. 2 (which was issued in May, 1980).

Financial Reporting Pursuant to GAAP

Financial statements prepared in accordance with GAAP can be derived from many different charts of accounts. There certainly is no standard chart of accounts under GAAP. An effective chart of accounts, however, lends itself to the production of GAAP financial statements with a minimum of adjustments. For the large ILECs, however, the results reported pursuant to the Part 32 Rules must undergo substantial adjustments to convert such regulatory results to a GAAP basis suitable for Securities and Exchange Commission ("SEC") reporting. Thus, Snavely King's assertion that "Since external financial reports are derived from the Part 32 accounting, the USOA is obviously useful for external reporting"[10] is simply backwards and wrong.

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[9] Id., ¶ 93 and 96.

[10] Snavely King Report, pp. 12-13.

ARTHUR ANDERSEN LLP
SUPPLEMENT TO JULY 15, 1998 POSITION PAPER
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

NOVEMBER 10, 1998

The Need for Accounting Safeguards

Snavely King asserts that Class A accounting detail is necessary in order to "make meaningful cost allocations pursuant to its Part 64 Rules for the separation of regulated and non-regulated costs."[11] While Snavely King's statements regarding the different "attribution" of certain plant assets are generally true, their statement that Class A account detail is necessary to perform such allocations is not. The Part 64 rules "reflect a fully distributed costing methodology, with emphasis on direct assignment and cost causation."[12] The FCC's Part 64 cost allocation process is not dependent on Part 32 account information per se, but is driven by the grouping of homogenous costs that can be efficiently allocated to regulated/nonregulated operations based on common cost drivers/cost causative characteristics in each respective cost pool.[13]

While it uses the Class A level of account detail today, the Part 64 cost allocation process could be converted to a Class B level without any measurable impact on the regulated/nonregulated cost allocation results. To the extent that costs recorded in Class B accounts would have different cost characteristics, such costs would be categorized into homogenous cost pools and then directly assigned or attributed/allocated to regulated or nonregulated activities. The ILECs currently maintain numerous cost pools (often more than one thousand cost pools) within their cost allocation manuals in order to allocate costs on a cost causative basis to regulated and nonregulated activities. The movement from a Class A account structure to a Class B structure will not in any way impair the carrier's ability to allocate costs on a cost causative basis. The cost pool apportionment process would serve to continue to properly categorize costs into like categories and facilitate an accurate, efficient and effective allocation of costs between regulated and nonregulated activities.

In terms of regulatory reporting, the FCC obviously considers a reduced Class B level of detail adequate as such accounting and reporting is currently permitted today (for ILECs that qualify). In the Accounting Simplification NPRM, the FCC has proposed to permit Class B accounting and reporting for all ILECs except the RBOCs and GTE. We encourage the Commission to apply these adequate standards, which are consistent with current separations and access charge development processes already performed at the Class B level, to all ILECs.

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[11] Snavely King Report, p. 15. See also, Reply Comments of the Public Utility Commission of Texas filed on August 26, 1998 and the Pennsylvania Public Utility Commission filed on August 3, 1998 in the Accounting Simplification NPRM.

[12] *Separation of Costs of Regulated Telephone Services from Costs of Nonregulated Activities*, CC Docket No. 86-111, 2 FCC Rcd 1298 (1987), ¶ 2, [hereinafter Joint Cost Order.]

[13] Ameritech has demonstrated the accuracy and efficiency of cost allocations, fully consistent with the Commission's cost allocation principles, using a Class B account structure. See Comments of Ameritech filed July 17, 1998 in the Accounting Simplification NPRM at Attachment 4.

Under a Class B account structure, or even under full GAAP, accounting safeguards would continue to be present. The calculation of earned rates of return would certainly still be possible and earnings could be monitored consistent with the current environment for Class B companies.

The Need for Detail

Snavely King recommends that the Part 32 expense matrix and other subaccount detail be retained so that ILEC exogenous factor and cost of service projections can be evaluated. Here again, we find Snavely King's discussion lacking. Snavely King argues that expense matrix detail is necessary to facilitate the analysis and projection of labor costs separate from materials and other costs. We agree with part of this analysis - that the ILECs would study and evaluate labor costs and other activity-based information in support of operating and pricing decisions. However, Snavely King misses the point - this information is not meaningful on an account-by-account basis. Activity-based cost information, such as salaries and wages, is meaningful when reported or studied in total, or on a project or service basis. What is no longer meaningful is the prescribed multi-dimensional view by account as currently required in the "expense matrix."

Snavely King also relies heavily on the relationship between Class A detail and the performance of cost studies "of all types."[14] With respect to cost studies in the conventional revenue requirement use of the term, these cost studies are performed without specific information provided at a Class A account level of detail. Furthermore, these revenue requirement cost studies are performed currently for ILECs subject only to Class B requirements. This is a further indication that: (1) such studies can be performed without Class A accounting, and (2) it is possible that cost information may be efficiently obtained under either Class A or Class B accounting.

With respect to cost studies used to support retail services, unbundled network elements and the universal service fund, all of these studies use forward-looking long-run economic cost principles. Snavely King acknowledges the use of a forward-looking methodology,[15] but maintains that factors used in cost studies rely on USOA information. Snavely's concern is overstated. The difference in factors developed using Class A or Class B accounting is not significant given that the developed factors are applied to forward-looking investment balances. For Central Office Switching, Snavely shows that the Class B plant expense ratio factor is 0.054. The Class A plant expense ratio factors for Analog, Digital and Electro-

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[14] Snavely King Report, p. 8, pp. 16-17, pp. 18-19.
[15] Id., p. 8.

Mechanical Switching are 0.055, 0.054 and 0.122, respectively.[16] The difference between Class A and Class B is insignificant since the forward-looking investment, on which the factor will apply, is Digital Switching. In any event, management information system detail necessary for the development of plant specific factors would be retained. The retention of the entire Class A level account infrastructure is unnecessary for this purpose.

Snavely King is also incorrect when they assert that the expense matrix detail is necessary for the development of labor costs used in service cost studies and that regulators and the public must not be deprived of this cost detail.[17] Forward-looking cost studies do not use the book cost information in the expense matrix or any book cost information for that matter. Further, the evaluation of cost of service projections by regulators and the public are subject to detailed review and would not be impaired with the adoption of Class B accounting.

A chart of accounts based on and driven by meaningful management information would produce relevant cost of service information - information captured by product, service and customer segment. The routine production of such information would reduce the need for special cost studies and provide the requisite information for any necessary cost studies in the first place.

Depreciation Rates and Practices

Snavely King's statement that "Andersen's criticisms [of depreciation rates] are way out of date"[18] is unsupportable. Snavely King attempts to argue that, "as of January 1, 1998, the large ILECs had a [depreciation] reserve surplus of over $4.5 billion."[19] What Snavely King doesn't fully explain is that their Attachment 4, "Summary of Reserves On FCC Basis," compares only actual interstate reserve balances per the regulatory books (total company FCC basis) with "theoretical" depreciation reserve balances determined using currently authorized FCC methods and lives.[20]

The proper comparison, of course, is to compare the depreciation reserve levels determined pursuant to GAAP concepts with those determined pursuant to regulatory policies and requirements. Such an analysis was in effect performed by each of the large ILECs upon discontinuance of the application of Statement of Financial Accounting Standards ("SFAS") No.

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[16] Id., Attachment 2, p. 2.

[17] Id., p. 17.

[18] Id., p. 22.

[19] Id., p. 25.

[20] See also, Reply Comments of The Public Utilities Commission of Ohio filed on September 4, 1998 in the Accounting Simplification NPRM.

71, "Accounting for the Effects of Certain Types of Regulation,"[21] in producing their audited financial statements that are filed with the SEC and published to the financial community. This detailed review for each company not only reviewed the expected lives of the various asset classes but also analyzed the long-run recoverability of all network assets.

A summary of write-offs recorded by the large ILECs upon the discontinuation of SFAS No. 71, the vast majority of which related to historical underdepreciation of network plant assets, is included in Attachment 3 to this report. These write-offs totaled almost $42 billion on a pre-tax basis (almost $26 billion after-tax).

This disparity between the net realizable value of assets pursuant to GAAP and the net plant balances per the Part 32 USOA continues to exist as illustrated in Attachment 4 to this report. Attachment 4 compares depreciation reserves as of December 31, 1997 per the ILECs' GAAP basis financial statements with corresponding regulatory accounting reserves per the USOA. As illustrated in Attachment 4, the RBOCs and GTE currently experience a true depreciation reserve deficiency of approximately $34 billion. This deficiency related to existing plant is decreasing, as one would expect, as depreciable lives for external reporting purposes expire and plant is retired while regulatory depreciation continues through to its completion. However, reserve deficiencies related to plant additions subsequent to the above write-offs are created each year due to the continued disparity between economic lives used for financial reporting purposes and regulatory lives used for USOA accounting purposes. As can be seen, Snavely King's proposal to continue the status quo would only serve to exacerbate a significant problem.

Finally, the adoption of GAAP depreciation practices and methods for regulatory purposes by the FCC would not be unusual in today's environment. GAAP-based depreciation practices are being used in numerous states for intrastate regulatory purposes in recognition of the above economic disparities. In fact, the Coalition ILECs are currently allowed to use economic depreciation lives for regulatory accounting purposes in 15 states in which they operate.[22]

Property Units and BPR/CPR Requirements

Snavely King misunderstands our recommendations regarding simplification of property recordkeeping requirements. Our recommendations were proposed with the intent to more closely align GAAP requirements, asset management data needs and regulatory objectives.

[21] Statement of Financial Standards No. 71, "Accounting for the Effects of Certain Types of Regulation," [hereinafter SFAS No. 71].

[22] The Coalition ILECs are allowed to use GAAP depreciation methods for regulatory purposes in Alabama, Arkansas, California (eff. 1/1/99), Florida, Idaho, Michigan, Missouri, North Carolina, North Dakota, Oklahoma, Pennsylvania, South Dakota, Texas, Wisconsin and Wyoming.

Also intended was a closer alignment of the cost of maintaining the records with the needed reporting detail of the property records system. The cost associated with the current level of complexity clearly exceeds the benefit derived from such requirements. Transitional steps in this area would include:

- Redefining property units consistent with common asset management practices. In other words, property records should not be kept at a level of detail below the "functioning network component" level. Detailed components of property units should not be identified, recorded, tracked and retired separately - these items should be included as part of the asset to which they relate.

- Rely on GAAP with respect to the setting of reasonable expense limits or at a minimum replace the current zero dollar expense limit with respect to network assets with an agreed-on limit. As discussed above, the "fairly presents" standard under GAAP would not allow expense limits to be set at artificially high levels as Snavely King suggests.

Affiliate Transaction Rules

Finally, Snavely King does not offer any persuasive arguments in favor of retaining the burdensome asymmetrical affiliate transaction rules related to services provided between regulated ILECs and their nonregulated affiliates. In fact, Snavely King agrees with a key Andersen Paper transitional recommendation on establishing materiality thresholds or a rotational plan for fair market value ("FMV") studies to ease the burden on the ILECs should the current FMV rules adopted in the Accounting Safeguards Order[23] remain in effect. We encourage the Commission to implement these transitional recommendations now to reduce the ILECs' cost of compliance with the current rules.

Further, the GAAP principle of *Costs and Benefits* as discussed above is clearly at issue here. As shown in the Andersen Paper,[24] the costs of implementing/complying with the new FMV rules were significant as compared to the magnitude of adjustments recorded.

[23] *Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, CC Docket No. 96-150, FCC 96-490 (rel. December 24, 1996).
[24] Andersen Paper, p. 43.

ARTHUR ANDERSEN LLP
SUPPLEMENT TO JULY 15, 1998 POSITION PAPER
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

NOVEMBER 10, 1998

VII. SUMMARY AND CONCLUSIONS

In summary, the recommendations contained in the Andersen Paper can be implemented today to begin the transition process to streamline and simplify the accounting and reporting requirements for all ILECs to facilitate the industry's move to a competitive, deregulated environment. These short-term recommendations provide a reasoned, well-balanced approach to accounting simplification that will serve regulators and the industry well. These proposals, which upon examination are truly modest in scope, will not lessen the ability of the FCC and State Regulatory Commissions to enforce their Rules and the mandates of the Telecommunications Act. They will, however, provide each of the largest ILECs with added flexibility and an opportunity to redeploy on average $20 million in costs ($45 million including systems implementation costs) to activities that benefit customers and advance the competitive telecommunications environment. Ultimately, these transition steps should lead to full GAAP accounting and reporting for all ILECs.

Attachment 1

ARTHUR ANDERSEN LLP
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY
PROPOSED ACCOUNTING SIMPLIFICATION TRANSITION CHART

Arthur Andersen Recommendations	Change Immediately (1999)	Short-term Solution (2-3 years)	Long-term Solution
Part 32 Accounting & Reporting:			
Adopt Class B Accounting and Reporting	X		
Reduce/Eliminate Subsidiary Records	X		
Eliminate Expense Matrix	X		
Incorporate GAAP Materiality Standards			X
Adopt GAAP Notification Standards	X		
Property Records & Depreciation:			
Property Record Plan Changes-No Notification	X		
Eliminate Excessive Subaccounts/Records		X	
Average Cost Asset Accounting		X	
Asset Tracking by General Location		X	
Implement Expense Limit for Network Plant		X	
Flexible Depreciation Practices	X		
Affiliate Transactions Rules:			
Materiality-based/Rotational FMV Studies	X		
Expand FMV Study Affiliate Exemption Rules:			
- Apply Exemption by Service/Product Line	X		
- Apply to Transactions to Exempt Affiliates	X		
Eliminate Asymmetrical Rules for Services		X	
Eliminate Prevailing Price Limiting Criteria		X	
Full GAAP Accounting & Reporting			X

ARTHUR ANDERSEN LLP
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY
SUMMARY OF SNAVELY KING MISSTATEMENTS

Snavely King Misstatement	Actual Andersen Paper Statement
1. Andersen would relax the rules on affiliate transactions by eliminating the asymmetrical valuation of assets transferred and services provided... (p. 2)	The Andersen recommendations only apply to the asymmetrical valuation of services as discussed on page 6 of the Andersen Paper.
2. Andersen does not describe the "existing regulatory and competitive paradigm" that the USOA purportedly fails to reflect. (p. 4)	See detailed discussion on pages 11 to 13 in the Andersen Paper, where AA lists and discusses numerous events that have happened since the inception of the USOA, such as price cap regulation, the Telecommunications Act and the changing competitive landscape.
3. Andersen next condemns the USOA for having evolved into a "regulatory reporting system solely to meet regulatory reporting requirements." (p. 5)	Statements made in the Andersen Paper were factual and did not "condemn" the USOA – the USOA simply adds cost to the management and financial reporting processes as shown in Section V of the Andersen Supplement.
4. The sole purpose of the USOA is for regulation. If it has other uses, they are an added benefit, but if there are no such other uses, that is irrelevant. (p. 5)	Contrary to the overall "mission statement" of Part 32 - see Section 32.1 as referenced on page 2 of the Andersen Paper. Also contradicted by Snavely misstatement #11.
5. A USOA that fully serves both regulatory and management accounting objectives is therefore impossible. (p. 5)	See above - this is obviously untrue. All this requires is a partnership effort between the industry and regulators.
6. Financial reporting and the underlying GAAP concepts are designed to protect public shareholders from inconsistencies of financial results by company managements. (p. 6)	See GAAP discussion in Section VI of the Andersen Supplement. The purpose of GAAP is to facilitate the "fair presentation" of financial statements for the benefit of all users of such financial information.
7. An added expenditure of $10.5 million, or even $13.5 million, in the public interest, can be considered a trivial cost burden. (p. 7)	See Section V of the Andersen Supplement. An average "cost burden" of $21 million (or even $13.5 million) is not trivial by any standards.

ARTHUR ANDERSEN LLP
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY
SUMMARY OF SNAVELY KING MISSTATEMENTS

Snavely King Misstatement	Actual Andersen Paper Statement
8. Notably, Andersen never addresses the specific statutory requirements identified in paragraph 6 of the Accounting NPRM, nor does it consider the need of State commissions for consistent regulatory reporting. (p. 7)	As discussed in Section IV of the Andersen Supplement, the recommendations contained in the Andersen Paper do not compromise the Commissions' ability to fulfill their statutory obligations with respect to audit, monitoring or enforcement of the regulatory accounting process.
9. Detailed historical cost data provides the foundation for every reliable service cost study. Without the benefit of detailed historical cost data, such studies cannot be properly prepared or evaluated (p. 8)	What Snavely never does is address the fact that Class B historical accounting information, or even GAAP-based financial results, would also provide a more than adequate basis for the preparation of service cost studies.
10. The Telecommunications Act of 1996 has increased, not decreased, the requirement for detailed cost data ... (p. 8)	This statement is nowhere to be found in the Telecommunications Act and is contrary to its mandate to provide for a deregulatory framework.
11. As will be discussed throughout this report, the Commission's current rules strike an appropriate balance between the interests of investors and those of ratepayers. (p. 10)	This statement is contradicted several times within the Snavely King Report itself. Refer to Snavely misstatements #4 and #5.
12. Andersen's <u>criticisms</u> ignore the primary purpose of Part 32. (p. 11)	See Snavely misstatement #4. See also Section 32.1 of the USOA, which states that the revised USOA will allow reporting of results to be used by regulators, management and the financial community.
13. Since external financial reports are derived from the Part 32 accounting, the USOA is obviously useful for external reporting. (p. 13)	See discussion in Section V of the Andersen Supplement. This could be said about any chart of accounts, no matter what its relevance is to the company's operations, its industry, or its peer group.

ARTHUR ANDERSEN LLP
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY
SUMMARY OF SNAVELY KING MISSTATEMENTS

Snavely King Misstatement	Actual Andersen Paper Statement
14. Similarly, Andersen states that "the LECs believe that removing Part 32 completely would not necessarily result in fewer accounts, because many of those accounts would still be necessary for management purposes." It is hard to reconcile this statement with Andersen's contention that the Coalition LECs "are not able to use Part 32 to capture useful management information." (p. 13)	Snavely King apparently did not read the very next sentence in the Andersen Paper which states, "However, the focus could be shifted towards providing meaningful management information within a simplified (Class B) chart of accounts structure." (p. 21)
15. Since most of its survey companies are assumedly non-regulated, this difference might generally be viewed as a cost of regulation. As such, it represents a real bargain. (p. 14)	Actually, approximately one-half of the studied companies were regulated entities and not solely in the telecommunications industry.
16. It is interesting to note that the USOA for these [electric utilities] companies, as prescribed by the Federal Power Act (18 CFR 101), contains far <u>more</u> accounts (396) than the USOA for telephone companies (261). (p. 14, footnote 25)	What Snavely doesn't say is that the FERC USOA contains separate accounts for the major power generation segments - including nuclear, coal, hydro and steam generation, etc. Eliminating this repetition, the FERC chart of accounts only has marginally more accounts. After taking into consideration the expense matrix, an extra dimension of detail required by the FCC USOA (virtually increasing the number of expense accounts by a factor of <u>four</u>), the FCC requires more detailed information to be maintained in the chart of accounts than does the FERC.
17. A move to Class B accounting would deprive the Commission of data needed to make meaningful cost allocations pursuant to its Part 64 Rules for the separation of regulated and non-regulated costs. (p. 15)	This is an inaccurate statement - see Sections IV and VI of the Andersen Supplement. The Part 64 Rules apply <u>today</u> to ILECs subject to the Class B accounting rules.
18. Ironically, Andersen itself notes that activity-based cost information (e.g. salaries and wages) is often a focus of management information systems used to present a clear picture of activities performed to produce a product or service. (p. 17)	Yes, but <u>not</u> on an account-by-account basis. The focus of most charts of accounts is on the production of meaningful management information that rolls up to produce financial information in accordance with GAAP.

ARTHUR ANDERSEN LLP
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY
SUMMARY OF SNAVELY KING MISSTATEMENTS

Snavely King Misstatement	Actual Andersen Paper Statement
19. Andersen's reference to ILEC competitors is irrelevant. (p. 18)	The Commission's responsibilities under the Telecommunications Act include the advancement of competition in all markets. The availability of comparable financial data would allow the FCC and State Commissions to benchmark performance and assess the reasonableness of interconnection, resale and resultant end user customer rates.
20. As discussed above, GAAP protects the interests of investors, not ratepayers. The SEC's responsibilities are similarly focused, as are those of independent auditors, such as Arthur Andersen. (p. 19)	See discussion of GAAP in Section VI of the Andersen Supplement, where it is described how both shareholders and ratepayers are protected with the effective application of GAAP.
21. Andersen is <u>highly critical</u> of the depreciation rates prescribed by the Commission. Andersen's <u>criticisms are way out of date</u>. (p. 22)	See Section VI of the Andersen Supplement for a complete discussion of depreciation issues, including the history and use of the USOA accounting rules and the correct comparison of depreciation reserve levels and deficiencies.
22. If the Commission were prescribing depreciation rates based upon historical indicators, it would be prescribing depreciation rates in the range of 3 to 5 percent. This rise in reserve levels has largely eliminated reserve deficiencies for the large ILECs. In summary, Andersen's criticism of the depreciation rates currently prescribed by the Commission is unfounded. (p. 25)	See Section VI and Attachment 4 of the Andersen Supplement which shows depreciation reserve deficiencies totaling approximately $34 Billion, which demonstrates a continuing significant problem for the ILECs.
23. Given their incentive to keep regulated earnings low, and the conservative bias of GAAP, it is likely that the ILECs would find it appropriate to raise their depreciation rates to levels which would best protect investor interests. In essence, they would be <u>prematurely freed from economic regulation</u>. (p. 26)	See Section VI of the Andersen Supplement. Should regulatory and financial reporting be consistent, then the "objective" of keeping regulatory earnings low would be directly mitigated by the "objective" of reporting earnings that meet or exceed analyst and investor expectations.

ARTHUR ANDERSEN LLP
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY
SUMMARY OF SNAVELY KING MISSTATEMENTS

Snavely King Misstatement	Actual Andersen Paper Statement
24. In summary, Andersen's recommendation on depreciation would <u>threaten</u> not only the maintenance of just and reasonable rates, it would also adversely affect the Commission's competition and universal service initiatives. (p. 26)	Snavely King ignores the GAAP objectives of financial reporting which call for the depreciation of assets over their "economic" lives as discussed on pages 30 and 35-36 of the Andersen Paper.
25. Andersen recommends that the ILECs be given <u>free reign</u> to consolidate plant accounts and roll-up Continuing Property Records ("CPRs") into higher-level retirement units. (p. 27)	Obviously, management would need to maintain sufficiently detailed plant accounts and underlying property records in order to effectively manage company assets and comply with GAAP requirements as discussed on pages 33-34 of the Andersen Paper.
26. The establishment of <u>inordinately high</u> expense limits, for example, would increase the expenses reported by an ILEC in a given period. Since this would tend to understate reported income, rather than overstate it, it would be considered a "conservative" practice under GAAP. (p. 30)	Expense limits are a materiality-based accounting convention to be used only when the costs exceed the benefits of applying GAAP. Setting of "inordinately high expense limits" would not be allowed under GAAP if financial results are materially impacted.
27. The ILEC alone determines which assets will be placed on the books of each of its organizational entities, and which services will be provided to other entities. (p. 33)	This statement implies that separate subsidiaries, including the ILEC's corporate holding company, have no say in asset purchase, resource allocation and service/ product decisions. This is, of course, untrue.
28. While the 50% [prevailing price] requirement may be somewhat arbitrary, it represents a <u>reasonable balance</u> between the interests of investors and those of ratepayers. (p. 34)	What benefits do investors realize from this requirement? In reality, investors and ratepayers both lose in this area due to the increased costs incurred by the ILECs to comply with this detailed requirement.
29. Andersen's recommendation that the Commission place full reliance on GAAP ignores the fact that GAAP protects investors and not necessarily ratepayers. (p. 37)	See Section VI of the Andersen Supplement for a discussion of GAAP and its objectives, where it is shown that the attributes of GAAP, collectively, serve to protect all users – shareholders, regulators, ratepayers, financial analysts and creditors, among others.

ARTHUR ANDERSEN LLP
ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNCATINS INDUSTRY

SUMMARY OF SFAS NO. 71 DISCONTINUANCE WRITE-OFFS

(Dollars in Billions)

Company	Effective Date	Write-off Amount		Depreciation Reserve Ratio	
		Pre-tax	After-tax	Before	After
U S WEST	3Q93	$5.1	$ 3.2	35%	57%
Bell Atlantic	3Q94	3.7	2.2	38%	52%
Ameritech	4Q94	3.9	2.3	43%	55%
BellSouth	2Q95	4.4	2.7	44%	55%
NYNEX	2Q95	4.6	2.9	44%	53%
SBC Communications	3Q95	4.6	2.8	44%	61%
Pacific Bell	3Q95	5.7	3.3	41%	58%
Frontier	3Q95	0.2	0.1	48%	60%
GTE	4Q95	7.4	4.7	43%	61%
Sprint	4Q95	1.0	0.6	47%	55%
SNET	4Q95	1.2	0.7	41%	71%
		$41.8	$25.5		

Source: Annual Reports on Form 10-K filed with the Securities and Exchange Commission.

Arthur Andersen LLP
Accounting Simplification in the Telecommunications Industry

Regional Bell Operating Companies and GTE Telephone Operating Companies
Summary of Depreciation Reserve Deficiencies at December 31, 1997

(Dollars in Millions)

		FCC Part 32 Basis		SEC External Reporting Basis		Reserve Deficiency	
Company	Depreciable Plant	Depreciation Reserve	Percent	Depreciation Reserve	Percent	Amount	Percent
	(a)	(b)	(c) = (b) / (a)	(d)	(e) = (d) / (a)	(f) = (d) - (b)	(g) = (f) / (a)
Ameritech:							
Illinois Bell	$9,472.5	$4,547.9	48.0%	$5,588.9	59.0%	$1,041.0	11.0%
Indiana Bell	3,281.7	1,750.8	53.4%	2,111.1	64.3%	360.3	11.0%
Michigan Bell	8,294.0	4,422.7	53.3%	5,425.9	65.4%	1,003.2	12.1%
Ohio Bell	6,213.6	3,174.5	51.1%	3,939.8	63.4%	765.3	12.3%
Wisconsin Bell	3,010.6	1,505.8	50.0%	1,836.7	61.0%	330.9	11.0%
	30,272.4	15,401.7	50.9%	18,902.4	62.4%	3,500.7	11.6%
Bell Atlantic:							
Deleware	779.6	352.3	45.2%	404.2	51.8%	51.9	6.7%
Maryland	5,789.3	2,607.7	45.0%	3,271.8	56.5%	664.1	11.5%
New Jersey	9,561.6	4,478.8	46.8%	5,597.0	58.5%	1,118.2	11.7%
New England	13,114.4	6,555.3	50.0%	7,476.2	57.0%	920.9	7.0%
New York	21,018.0	10,058.3	47.9%	11,967.5	56.9%	1,909.2	9.1%
Pennsylvania	9,626.2	4,555.8	47.3%	5,750.4	59.7%	1,194.6	12.4%
Virginia	5,846.3	2,637.8	45.1%	3,265.8	55.9%	628.0	10.7%
Washington, D.C.	1,626.1	672.1	41.3%	849.6	52.2%	177.5	10.9%
West Virginia	1,718.5	902.5	52.5%	1,032.2	60.1%	129.7	7.5%
	69,080.0	32,820.6	47.5%	39,614.7	57.3%	6,794.1	9.8%
BellSouth Telecommunications	47,706.0	24,147.1	50.6%	29,015.0	60.8%	4,867.9	10.2%
SBC Corporation:							
Southwestern Bell	30,670.0	14,358.6	46.8%	18,460.0	60.2%	4,101.4	13.4%
Pacific Bell	28,886.0	13,404.0	46.4%	17,606.0	60.9%	4,202.0	14.5%
	59,556.0	27,762.6	46.6%	36,066.0	60.6%	8,303.4	13.9%

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Arthur Andersen LLP
Accounting Simplification in the Telecommunications Industry

Regional Bell Operating Companies and GTE Telephone Operating Companies
Summary of Depreciation Reserve Deficiencies at December 31, 1997

(Dollars in Millions)

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Company	Depreciable Plant	Depreciation Reserve	Percent	Depreciation Reserve	Percent	Amount	Percent
	(a)	(b)	(c) = (b) / (a)	(d)	(e) = (d) / (a)	(f) = (d) - (b)	(g) = (f) / (a)
U S WEST Communications	32,572.0	15,116.9	46.4%	19,041.0	58.5%	3,924.1	12.0%
Total RBOCs	239,186.4	115,248.9	48.2%	142,639.1	59.6%	27,390.2	11.5%
GTE Telephone Operations:							
GTE North	9,221.4	4,605.7	49.9%	6,432.4	69.8%	1,826.7	19.8%
GTE California	10,253.3	5,214.7	50.9%	6,278.6	61.2%	1,063.9	10.4%
GTE Florida	4,229.3	1,852.8	43.8%	2,470.5	58.4%	617.7	14.6%
GTE South	3,162.5	1,500.4	47.4%	2,664.0	84.2%	1,163.6	36.8%
GTE Southeast	5,243.8	2,434.1	46.4%	3,317.2	63.3%	883.1	16.8%
GTE Northwest	3,263.1	1,365.6	41.8%	2,127.1	65.2%	761.5	23.3%
GTE Hawaii	1,781.7	738.3	41.4%	1,173.9	65.9%	435.6	24.4%
	37,155.1	17,711.6	47.7%	24,463.7	65.8%	6,752.1	18.2%
Total RBOCs and GTE	$276,341.5	$132,960.5	48.1%	$167,102.8	60.5%	$34,142.3	12.4%

Notes to Schedule:

(1) - Depreciable plant amounts were obtained from Annual Reports filed on Form 10-K as of December 31, 1997.
(2) - Part 32 depreciation reserve amounts were obtained/accumulated from Snavely King Report (Attachment 4).
(3) - GTE Midwest and GTE/Contel of Virginia amounts were excluded from this schedule as Form 10-Ks are not filed for those subsidiaries.

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