BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

In the Matter of Qwest Corporation's Motion for an Alternative Procedure to Manage the Section 271 Process	**Case No. USW-T-00-3**

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES BOARD

IN RE: QWEST CORPORATION	**DOCKET NO. INU-00-2**

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER OF the Investigation Into Qwest Corporation's Compliance with Section 271 of the Telecommunications Act of 1996	**Docket No. D2000.5.70**

STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

Qwest Corporation Section 271 Compliance Investigation	**Case No. PU-314-97-193**

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Qwest Corporation for Approval of Compliance with 47 U.S.C. § 271(d)(2)(B)	**Docket No. 00-049-08**

BEFORE THE PUBLIC SERVICE COMMISSION OF WYOMING

IN THE MATTER OF THE APPLICATION OF QWEST CORPORATION REGARDING 271 OF THE FEDERAL TELECOMMUNICATIONS ACT OF 1996, WYOMING'S PARTICIPATION IN A MULTI-STATE SECTION 271 PROCESS, AND APPROVAL OF ITS STATEMENT OF GENERALLY AVAILABLE	**DOCKET No. 70000-TA-00-599**

BEFORE THE NEW MEXICO REGULATION COMMISSION

IN THE MATTER OF Qwest Corporation's Section 271 Application and Motion for Alternative Procedure to Manage the Section 271 Process	**Utility Case No. 3269**

Qwest's Submission of Results of Independent Testing

Qwest Corporation (the "BOC") herewith respectfully submits the attached report ("KPMG Report") of KPMG LLP ("KPMG"), conducted in accordance with the recommendation in Part IV (Section 272) of the Multistate Facilitator's Report on Group 5 Issues: General Terms and Conditions, Section 272 and Track A, dated September 21, 2001 ("Report"). Additionally, the affidavits of Judith L. Brunsting and Marie E. Schwartz are attached. These affidavits address the findings of the KPMG Report and the controls instituted in response thereto.

Introduction

Earlier this year, the BOC engaged in what the Facilitator concluded were "substantial efforts" to retool Qwest Communications Corporation ("the 272 Affiliate") to be its future provider of in-region interLATA service. Report at 53-54. In order to validate and reinforce these efforts, the BOC has now taken the further unprecedented and valuable step recommended by the Facilitator of submitting to a *pre-approval* review of its Section 272 accounting controls.

As noted below in greater detail, the KPMG Report concludes that except in 12 instances, both the BOC and the 272 Affiliate complied in all material respects with the applicable FCC accounting rules. KPMG's examination was comprehensive. It did not exclude transactions of a *de minimis* nature (*see id.* at 56): at least half of these 12 instances had a financial impact of less than $25,000.[1] Nor was it confined to transactions in which the BOC was the "vendor or supplier" of services to the 272 Affiliate (*see id.* at 54): seven of them involved the provision of services *from* the 272 Affiliate *to* the BOC. Nor did KPMG limit its review to transactions in which the error resulted in the kind of "anticompetitive discrimination and cost-shifting" against which Section 272 was designed to protect:[2] the net financial impact of all 12 transactions worked to the 272 Affiliate's *detriment*. The overarching goal of Section 272's separation and nondiscrimination provisions is to prevent the BOC from advantaging its 272 affiliate over that affiliate's competitors.

Most of these transactions also involved errors previously identified by the BOC and the 272 Affiliate themselves. Nevertheless, because they take their 272 responsibilities seriously and strive to improve procedures to aid in compliance with those requirements, the BOC and the 272 Affiliate have undertaken a careful review of KPMG's findings, in an effort to identify aspects in which their existing controls can be strengthened in preparation for the 272 Affiliate's future provision of in-region interLATA service. As set forth in the attached affidavits, they have taken the appropriate steps to correct these errors, and are reinforcing and supplementing training programs and other controls to assist them in their ongoing efforts to ensure procedures "reasonably designed to prevent, as well as detect and correct, any noncompliance with section 272."[3] As the FCC has recognized, the requirements of further expert review through section 272(d) biennial audits following 271 authorization also "will provide an appropriate mechanism for detecting potential anticompetitive or otherwise improper conduct."[4] In light of all of these

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1 The Facilitator concluded that "the concept of materiality should remain a part of evaluating compliance with § 272(b)(2)," based on the universe of transactions between the BOC and the 272 Affiliate during the relevant time period. Report at 9, 56.

2 Report and Order, *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, 11 FCC Rcd 17,539 (1996) ("*Accounting Safeguards Order*"); First Report and Order and Further Notice of Proposed Rulemaking, *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as Amended*, 11 FCC Rcd 21,905 ¶ 9 (1996) ("*Non-Accounting Safeguards Order*").

3 Memorandum Opinion and Order, *Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services in Texas*, 15 FCC Rcd 18,354 ¶ 398 (2000) ("*SBC Texas Order*"); Memorandum Opinion and Order, *Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York*, 15 FCC Rcd 3953 ¶ 405 & n.1253 (1999), *aff'd sub nom AT&T Corp. v. FCC,* 220 F.3d 607 (D.C. Cir. 2000) ("*BANY Order*").

4 *SBC Texas Order* ¶ 406. *See also BANY Order* ¶ 412.

factors, the record now convincingly demonstrates that, when granted, the BOC's future Section 271 authorizations "will be carried out in accordance with the requirements of section 272." 47 U.S.C. § 271(d)(3)(B).

Background

The Facilitator concluded that "[t]he record demonstrates that Qwest has met . . . each of the separate affiliate requirements established by section 272 of the Telecommunications Act of 1996." Report at 7. In reaching this conclusion, the Facilitator examined the record with respect to both of the BOC's successive Section 272 affiliates: U S WEST Long Distance, Inc. (subsequently renamed Qwest Long Distance, Inc. ("Qwest LD")), and the 272 Affiliate, which became the BOC's designated 272 affiliate effective March 26, 2001.

With respect to the extensive prior record of Qwest LD over many years, the Facilitator found nothing in the record of "sufficient concern to warrant special measures." *Id*. at 54. With respect to the 272 Affiliate, the Facilitator acknowledged the "substantial efforts" that the BOC undertook during the recent transition to its newly designated 272 Affiliate "to bring its transactions, both past and current, into compliance with applicable accounting requirements." *Id*. In order to test the "current and future effectiveness of the[se] recent improvement efforts" following the completion of that transition, the Facilitator recommended that the BOC arrange for independent testing of transactions between the BOC and the 272 Affiliate covering the ensuing period from April through August 2001. He recommended that the BOC provide the results of the independent testing, along with supporting workpapers, to the seven multistate commissions by November 15, 2001. *Id*. at 8, 54.[5]

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[5] In accordance with the American Institute of Certified Public Accountants Professional Standards, AT § 9100.56; AU § 339.02-.08; AU § 9339.02 (2000)), KPMG will make these workpapers available to the seven state commissions for their review, subject to confidentiality restrictions, at mutually convenient times and locations in each of the seven states.

The Facilitator determined that the third-party evaluation is intended to provide "adequate assurances" that the 272 Affiliate is prepared to comply with certain provisions of Section 272 upon receipt of Section 271 authority. *Id*. Such assurances do not require "perfection," which is a standard that "could not be met in . . . the operations of any wholesale supplier." *Id*. at 56. As noted above, the significant question here is whether the BOC and the 272 Affiliate have sufficient controls in place that are "reasonably designed to prevent, as well as detect and correct, any noncompliance with section 272."[6]

Summary of KPMG Report

KPMG examined transactions that occurred between the BOC and the 272 Affiliate during the period April through August 2001. During the course of its examination, KPMG found items in its testing that confirm the BOC's earlier testimony that a number of transactions related to the transition of the 272 Affiliate were discovered and corrected to effect Section 272 compliance. With respect to new transactions occurring during the five-month test period, KPMG determined that except for 12 instances identified in the attached KPMG Report, the BOC complied "in all material respects" with Sections 272(b)(2), (b)(5), and (c)(2) and the applicable FCC accounting rules.[7]

The exceptions noted in the KPMG Report do not raise any of the anti-competitive and cross-subsidization concerns underlying the relevant Section 272 requirements. The underlying purpose of the affiliate pricing rules and the accounting requirements of Sections 272(b)(2) and

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6 *SBC Texas Order* ¶ 398 (2000); *BANY Order* ¶ 405 & n.1253.

7 KPMG's comprehensive examination also identified instances of noncompliance during the testing period that KPMG determined were not material. KPMG's analysis of discrepancies divided instances of noncompliance into four categories: Type 1 includes items that occurred before the examination period and were corrected during the period; Type 2 includes items that occurred during the examination period and were corrected during the period; Type 3 includes items that KPMG determined were clerical in nature; and Type 4 includes items that occurred during the examination period and were not resolved during the period. The Type 4 items are those identified in the attached KPMG report.

(c)(2) is to ensure that an incumbent LEC does not cross-subsidize its nonregulated activities.[8] The same policy forms the basis for Section 272(b)(5)'s requirement that a 272 affiliate conduct all transactions with the BOC "on an arm's length basis,"[9] and Section 272(c)(1)'s provision that a BOC may not discriminate in favor of its 272 affiliate, which are designed to ensure that "potential competitors do not receive *less favorable* prices or terms, or *less advantageous* services from the BOC than its separate affiliate receives."[10] The instances cited in the attached KPMG Report, and discussed below, do not suggest any policy of the BOC of discriminating in favor of its 272 Affiliate. On the contrary, they involve a net *detriment* to the 272 Affiliate of $2.604 million.

As set forth in the Issue Descriptions included with the KPMG workpapers, in most of these 12 instances, the BOC or the 272 Affiliate themselves detected the need for corrective action. As discussed more fully below, based on its review of the few remaining instances, the BOC is strengthening its internal controls in efforts to prevent any such discrepancies in the future. These instances do not undermine the BOC's showing that it "accepts the separate subsidiary obligation and stands ready to meet it" (Report at 50), particularly after the implementation of these additional controls.

1. Affiliate Pricing Rules. Four of these instances relate not to the question of timely accounting or posting, but rather to the application by the BOC or the 272 Affiliate of the valuation procedures for the FCC's affiliate pricing rules set forth in 47 C.F.R. Part 32. Overall,

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8 *See* Report and Order, *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, 2 FCC Rcd 1298 ¶¶ 254-56 (1987). *See also* Report and Order, *Accounting Safeguards Under the Telecommunications Act of 1996*, 11 FCC Rcd 17,539 ¶¶ 172, 176 (1996) ("*Accounting Safeguards Order*"). In the *Accounting Safeguards Order*, the FCC determined that it would extend the application of these affiliate pricing rules to transactions between a BOC and its 272 affiliate. *Id*. ¶ 176.

9 *See Accounting Safeguards Order* ¶ 147 (the valuation rule "guard[s] against cross-subsidization of competitive services by subscribers to regulated telecommunications services").

these instances involve a net detriment to the BOC of only $21,000, and accordingly do not demonstrate any general policy of cross-subsidization or discrimination.

Nor do these transactions reveal any "systemic flaws"[11] in the BOC's compliance with the affiliate pricing rules. As set forth in the Issue Descriptions included with the KPMG workpapers, three of the four instances involved the use of fully distributed cost rather than fair market value.[12] The first of these involved 10 real estate properties made available by the BOC to 272 Affiliate employees; the error had an impact during the examination period of $3,000. The second involved real estate properties provided by the 272 Affiliate to the BOC and resulted in a net detriment to the BOC of about $9,000. The third such transaction resulted from an employee's pricing of lab facility services to the 272 Affiliate at fully distributed cost rather than fair market value, even though a chart designed by the BOC to aid in compliance with these rules had provided the fair market value information. The fourth listed transaction involved using the BOC's rather than the 272 Affiliate's inputs in calculating the 272 Affiliate's fully distributed cost.

While the BOC and the 272 Affiliate strive to properly and accurately calculate and record all of their affiliate transactions, some errors will and do occur. As the Facilitator recognized, perfection is not the relevant standard here. However, in order to continue reducing each company's error rate, the BOC and the 272 Affiliate are instituting additional safeguards at the corporate level of each company to ensure all material intercompany transactions are

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[10] *See* First Report and Order and Further Notice of Proposed Rulemaking, *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended,* 11 FCC Rcd 21,905 ¶ 206 (1996) (emphasis added).

[11] *BANY Order* ¶ 412.

[12] We note that the FCC has recently eliminated the requirement that carriers undertake fair market value studies for assets as well as services until the total amount of transfers in a given year exceeds $500,000. This change may be implemented by carriers as of January 1, 2001. *See* Report and Order and Further Notice of Proposed Rulemaking, 2000 Biennial Regulatory Review – Comprehensive Review of the Accounting

identified and billed at correct prices. The BOC and 272 Affiliate corporate regulatory compliance groups will improve the formal tracking mechanism for affiliate transactions. This list will be discussed with operational personnel and compared to databases to ensure that it is both complete and accurate. Additionally, the BOC will conduct additional training sessions with all relevant personnel concerning the FCC's affiliate transaction pricing rules. As an additional safeguard, supporting documentation will now be provided to the BOC's FCC Regulatory Accounting Department for verification of affiliate transaction pricing.

2. Timely Accounting and Posting. The remaining category of items identified in the KPMG Report relate to the timeliness of accrual or billing and reducing transactions to writing.[13] Although the combined impact of these eight errors was $2.625 million to the detriment of the 272 Affiliate, one transaction alone accounted for more than 94 percent of that total. Excluding that amount, the net impact of all of these transactions was $146,000 in underbilling of the 272 Affiliate's costs to the BOC. In every one of these cases, the BOC or the 272 Affiliate themselves detected the error. These instances do not reveal any systemic flaws, and Qwest has further strengthened its controls to address them following its review of the KPMG Report:

- The largest of these transactions involved the 272 Affiliate's provision of audio conferencing services to the BOC. Because in-region interLATA services had been spun off to Touch America and because pursuant to that arrangement the 272 Affiliate billed the BOC on Touch America letterhead, the procurement office erroneously assumed that these services were not transactions with an affiliate and failed to process a bill to the

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Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2, CC Docket No. 00-199, FCC 01-305 ¶¶ 87-90 (rel. Nov. 5, 2001).

[13] In one of these transactions, there was no untimely accrual or billing, but only a failure to comply with the FCC's posting requirements. Qwest discovered that corporate calling card services, which had been migrated from Qwest LD to the 272 Affiliate with pricing set at prevailing company prices, were not listed. Qwest has strengthened its existing controls by implementing a monthly review of all BOC intercompany payables and establishing a 272 checklist to track all new services provided by the 272 Affiliate to the BOC.

BOC and receive payment. The procurement employee responsible for the nonpayment was reassigned in June 2001, and the processing error has been identified and corrected.

- A similar error involved private line services that previously had been provided to the BOC by Touch America, most of which were not moved to the 272 Affiliate until September and October 2001. Because the 272 Affiliate's order entry system has a Section 271 protection that restricts creation of an in-region account, billing for the re-engineered circuits was not immediately possible, but internal controls nevertheless identified the need to bill and post this transaction, which was accomplished manually (but after the test period). Qwest is now developing an overall automated solution to handle intercompany provision of interLATA services, while maintaining the system's built-in Section 271 protections.

- In the course of the company's annual affiliate transaction repricing, the BOC discovered that it had provided photo identification badges to the 272 Affiliate's employees without reducing the service to writing, posting it, and billing it properly. Having detected and corrected the problem through existing controls, the BOC will minimize further discrepancies by conducting additional training to emphasize the use of department and responsibility codes so new badges can be charged to the appropriate entities on a timely basis.

- Internal controls also detected a failure to identify for affiliate transaction purposes the BOC's pre-merger lease of a dark fiber link in Utah from the 272 Affiliate. Regulatory Accounting subsequently obtained a copy of the lease and developed and posted a Task Order and corrected the billing error. Qwest Network Construction Services has now instituted procedures for quarterly review of billing systems and for immediate notification to the 272 Affiliate regarding any actual or proposed transaction with the BOC.

- The BOC became aware that a total of 40 out of approximately 64,000 BOC employees, including 10 scattered among nine out-of-region facilities, were occupying the 272 Affiliate's real estate and using its PBX services. Qwest has added audit processes to its Human Resources and Real Estate organizations to detect movements of small numbers of employees in the future.

- During the transition of the 272 Affiliate, experienced BOC finance personnel performed a very minor project for the Affiliate, involving the calculations of FDC values for affiliate pricing rule purposes. That work totaled approximately $1000, and was not billed. The BOC has corrected the error and strengthened its notifications to finance personnel regarding time reporting for *any* services provided to affiliates.

- The BOC provides several types of services to the 272 Affiliate related to small business and consumer services under a properly posted and billed work order. The BOC found that the work of two employees who had been handling data entry related to such services had been missed in these routine billings. The BOC has corrected the error and enhanced its reviews and training regarding Section 272 requirements.

Conclusion

As discussed above, in response to these findings, the BOC is implementing strengthened controls, which serve to reinforce the "substantial efforts" (Report at 54) already undertaken to prepare the 272 Affiliate to comply with the separate affiliate requirements. These additional controls confirm that there are "reasonable assurances" (*Id*.) that the BOC and the 272 Affiliate will provide the level of accuracy, completeness, timeliness and arm's length conduct required by Section 272. As to the first category of exceptions in the KPMG Report (affiliate pricing), the BOC will conduct additional training sessions and document review to ensure compliance with the FCC's valuation procedures. With respect to the second category (timely billing and accruing of transactions), the BOC is instituting new procedures, additional regular review processes, and further training to ensure procedures "reasonably designed to prevent, as well as detect and correct, any noncompliance with section 272."[14] The requirements of further expert review through Section 272(d) biennial audits following 271 authorization will supplement these controls to aid in the efforts of the BOC and the 272 Affiliate to comply with the separate affiliate requirements.

In light of the BOC's and the 272 Affiliate's strengthened controls, and the prior record of compliance by Qwest LD and the 272 Affiliate with all of the other requirements of Section 272, as confirmed by the Facilitator, the BOC respectfully requests that the Commission endorse the Facilitator's conclusion that "[t]he record demonstrates that Qwest has met . . . each of the separate affiliate requirements established by section 272 of the Telecommunications Act of 1996." Report at 7.

[14] *SBC Texas Order* ¶ 398; *BANY Order* ¶ 405 & n.1253.