ORAL ARGUMENT NOT YET SCHEDULED

BRIEF FOR RESPONDENTS

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

NO. 05-1171

AT&T CORPORATION,

Petitioner,

v.

FEDERAL COMMUNICATIONS COMMISSION
AND UNITED STATES OF AMERICA,

Respondents.

ON PETITION FOR REVIEW OF AN ORDER OF THE
FEDERAL COMMUNICATIONS COMMISISON

THOMAS O. BARNETT
ACTING ASSISTANT ATTORNEY GENERAL

ROBERT B. NICHOLSON
ROBERT J. WIGGERS
ATTORNEYS

UNITED STATES
DEPARTMENT OF JUSTICE
WASHINGTON, D.C. 20530

SAMUEL L. FEDER
ACTING GENERAL COUNSEL

RICHARD K. WELCH
ASSOCIATE GENERAL COUNSEL

JOHN E. INGLE
DEPUTY ASSOCIATE GENERAL COUNSEL

JOEL MARCUS
COUNSEL

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554
(202) 418-1740

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GLOSSARY

FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
LEC	Local Exchange Carrier
OPEB	Other Post-Employment Benefits
PCI	Price Cap Index. A limit on the rate a LEC may charge for a given “basket” of services.
RAO	Responsible Accounting Officer
SFAS-106	Statement of Financial Accounting Standards No. 106. Changed accounting for OPEBs from cash to accrual basis.
TBO	Transitional Benefit Obligation. A liability that represents the accrued amounts of OPEBs liabilities that were incurred before SFAS-106 took effect.
USOA	Uniform System of Accounts

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QUESTIONS PRESENTED

A 1992 Order issued by the Commission's staff erroneously directed local exchange carriers (LECs) to deduct from their rate bases amounts representing promised future employment benefits, such as life and dental insurance, to be provided after a current employee retires. The LECs complied with that directive while they challenged the staff order. Their compliance resulted in reduced rates of more than $100 million for the period from 1992 to 1995; the LECs' rate payers, such as petitioner AT&T, correspondingly enjoyed millions of dollars in rate reductions during that period. After the Commission reversed and rescinded the staff order, several LECs restated their rate bases and filed new tariffs that set forth rates that would recoup the foregone revenue for the period during which the LECs' rate bases and rates had been wrongfully reduced. In the order on review, the Commission approved those tariffs, thereby effectively placing the LECs in the position in which they would have been if the agency's staff had not erred.

Separately, in the same order, the Commission addressed Verizon's 1993 and 1994 tariffs, which contained rates that reflected Verizon's booked costs of future post-retirement employee benefits. The Commission had required carriers to account for such benefits on an accrual (as opposed to a cash flow) basis "on or before" a set deadline; Verizon began to account for the benefits before the deadline. In the order on review, the Commission found that Verizon's adoption of the new accounting practice after the Commission had adopted it, but before the compliance deadline, did not render the implementation of the accounting practice an action under Verizon's "control" within the meaning of rules that allow exogenous treatment only for costs that are beyond a carrier's control.

The questions presented are:

1) Whether the Commission properly waived two rules that arguably could have prevented the LECs from recovering their foregone revenues in order to place the LECs in the position they would have been in if the staff error had not occurred;

2) Whether AT&T may properly expand the scope of an FCC tariff investigation beyond the issues established by the agency.

3) Whether the Commission properly found that Verizon's adoption of an accounting practice before the mandatory deadline for doing so did not render that adoption within Verizon's control, and thus that Verizon was entitled to pass through the cost to rate payers.

JURISDICTION

The Court has jurisdiction over Commission tariff review decisions pursuant to 47 U.S.C. § 402(a) and 28 U.S.C. § 2342.

STATUTES AND REGULATIONS

All pertinent materials are set forth in petitioner's brief with the exception of 47 U.S.C. § 204(a) and 47 C.F.R. § 32.16(a), which we have attached hereto.

COUNTERSTATEMENT

This case concerns the FCC's regulatory treatment of "OPEBs" – other post-employment benefits – which are benefits other than pension benefits paid to retired workers. OPEBs typically include such things as life and dental insurance. *See Southwestern Bell Telephone Co. v. FCC*, 28 F.3d 165, 168 (D.C. Cir. 1994). In 1990, the board that regulates accounting practices mandated a change in the way companies account for OPEBs on their books. That change led in turn to questions about the rates that regulated carriers – here, local exchange carriers – charge long distance carriers for originating and terminating long distance telephone calls (known as access charges). As explained further below, the Commission's price cap ratemaking regulations did not immediately react to the changes in accounting practices. Although the staff authorized the LECs to use the new accounting method, in 1992 it misread the agency's regulations as requiring the LECs to exclude OPEBs liabilities from their rate bases. In early 1996, the Commission corrected the staff's error and amended its rules, effective 1997, to exclude the liabilities from the rate base. Through 1995, however, the LECs had filed tariffs that complied with the staff's directive, effectively resulting in rates lower than would have been allowed under the rules as properly construed. In the order on review, *1993 Annual Access Tariff Filings Phase I*, 20 FCC Rcd 7672 (2005) (*2005 OPEBs Order*) (JA), the Commission permitted the LECs to recoup their foregone revenues in their 1996 rates. Separately in the order on review, the Commission approved Verizon's 1994 tariff that sought to increase rates due to OPEBs liabilities booked under the new accounting rules.

A. Price Cap Regulation.

Traditionally, the rates telephone companies charged their customers were regulated by the FCC on a rate-of-return basis. In simple terms, the regulator calculated a company's rate base and multiplied the rate base by an allowed rate-of-return percentage to determine the permissible earnings for that year, which covered costs plus a reasonable return on debt and equity; rates were established to achieve that level of earnings. The Commission employed rate-of-return regulation to ensure that the carriers charged rates that were just and reasonable within the meaning of 47 U.S.C. § 201(b).

Rate-of-return regulation provided little incentive for carriers to be efficient or cost-conscious. Rather, the larger the rate base and the higher a company's costs, the more money it could earn. To combat that effect, the Commission in 1990 adopted price cap regulation for the largest carriers. *Rates For Dominant Carriers*, 5 FCC Rcd 6786 (1990) (*1990 Price Cap Order*). Under price cap regulation, the FCC sets a ceiling at or below which rates are presumed reasonable – the Price Cap Index (PCI) – for each one of several "baskets" of services the carrier provides. *See generally Bell Atlantic Telephone Cos. v. FCC*, 79 F.3d 1195 (D.C. Cir. 1996). Because the price cap rate is largely independent of changes in a carrier's costs or rate base, the carrier can earn more money by cutting its costs and thus has an incentive to operate more efficiently. *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993).

The initial PCIs were based on the carriers' rates under rate-of-return regulation, but the Commission established a mechanism for adjusting the PCIs yearly. Specifically, the

Commission implemented a formula for calculating future PCIs that allows an increase in the caps to reflect general price inflation but requires a decrease to reflect the amount by which the LECs' productivity is expected to exceed the productivity of the economy as a whole. *National Rural Telecom*, 988 F.2d at 178. The Commission also allowed adjustment to the PCIs to reflect "exogenous" costs – increases or decreases in costs that are not reflected in the general inflation factor and are not within the carrier's control: "in general those costs that are triggered by administrative, legislative or judicial action beyond the control of the carrier." *1990 Price Cap Order* ¶166. Costs that are within the carrier's control are considered "endogenous" and thus do not justify a separate increase in the PCI.

The price cap regime was not entirely independent of the rate-of-return regime. Each year, the Commission calculated the actual return earned by each carrier as a percentage of its rate base. A carrier that earned a return greater than an established maximum was required to "share" the excess earnings with its customers in the form of lower PCIs the following year to account for the overearnings. A carrier that earned a return below a set minimum was entitled to higher PCIs the following year to make up the difference. The latter process was known as "low end adjustment." *1990 Price Cap Order* ¶¶120-165; *see Bell Atlantic*, 79 F.3d at 1199. Sharing and low end adjustments were incorporated into the price cap index formula as "exogenous costs" under 47 C.F.R. § 61.45(d) (1995). The Commission eliminated sharing in 1997, but retained the low-end adjustment. *Price Cap Performance Review*, 12 FCC Rcd 16642, 16699-16703 ¶¶147-155 (1997).

B. Change In OPEB Accounting Rules.

Until 1990, carriers accounted for OPEBs on a cash basis; that is, the costs of those benefits were recorded on the company's books at the time they were actually paid to a former employee. In late 1990, the Financial Accounting Standards Board (FASB), a private body that serves as a quasi-official accounting standard-setting agency, adopted Statement of Financial Accounting Standards 106 (SFAS-106), which changed Generally Accepted Accounting Principles (GAAP) to require that OPEBs be accounted for on an accrual basis. Under SFAS-106, OPEB costs are booked at the time the benefits are earned by an employee, even though no money will be paid until the future. *See Southwestern Bell*, 28 F.3d at 167-168. In addition to requiring companies to book OPEB liabilities as they accrue, SFAS-106 also requires companies to record on their financial books as an accrued liability the amount of their unfunded obligation to pay OPEBs, called the transitional benefit obligation (TBO), that was in existence as of the date of their implementation of SFAS-106.

It is the Commission's policy to require that a carrier's regulatory accounting practices conform to GAAP, including new FASB standards, unless such a practice would conflict with the Commission's regulatory objectives. *See Revision of the Uniform System of Accounts*, 102 F.C.C.2d 964 (1985). Thus, the Commission's rules provide that a company's records "shall be adjusted to apply new accounting standards prescribed by" FASB. 47 C.F.R. § 32.16. In late 1991, several LECs notified the Commission of their intention to adopt SFAS-106. In response, in December 1991, the FCC's Common Carrier Bureau directed all regulated carriers to adopt SFAS-106 "on or before January 1, 1993." *Southwestern Bell*, 6 FCC Rcd 7560 (CCB 1991) (*SFAS-106 Order*). The Bureau required the LECs to account for the TBO by amortizing it over either 20 years or the average remaining service period of employee benefit plan participants, rather than recognizing the entire TBO as a one-time expense. *Id.* ¶5. The accounting change affected carriers' rates in two ways.

(1) Effect On Exogenous Costs.

First, the change in OPEB accounting raised the possibility that the booked OPEB liability represented an exogenous cost that could be passed through to customers in the form of increased PCIs. A number of LECs, including Bell Atlantic (a corporate predecessor of Verizon, which is the name by which we will refer to the company herein), informed the Commission that they would switch to accounting for OPEB costs on an accrual basis and accordingly filed tariffs that sought exogenous treatment for OPEB liabilities. Acting pursuant to 47 U.S.C. § 204, the Common Carrier Bureau suspended the tariffs for one day, imposed an accounting order, and began an investigation of that practice. *1992 Suspension Order*, 7 FCC Rcd 2724 (CCB 1992).

At the end of that tariff investigation, the Commission denied exogenous cost treatment to OPEBs, on the ground that "the level and timing" of the expenses were within the carrier's control and thus did not satisfy the criteria for exogenous treatment. *1992 Tariff Order*, 8 FCC Rcd 1024 (1993). This Court reversed that determination in *Southwestern Bell*, finding that "an FASB change adopted by the Commission is not a change under control of the carrier." *Southwestern Bell*, 28 F.3d at 170. The Court held that the Commission could not, under its applicable rules, deny exogenous treatment of an accounting change that the carrier was required by the agency to make, even though the carrier might have some "control" over the "level and timing" of the underlying expenses. *Ibid.*

The effect of the Court's decision was to allow carriers to raise their PCIs by the amount of the booked OPEB liability. Several LECs, including Verizon, accordingly filed revisions to their 1994 tariffs that sought exogenous treatment of previously denied OPEB amounts; Verizon sought exogenous treatment of OPEB amounts for 1991 and 1992. Ratepayers opposed the

Verizon tariff on the ground that Verizon was not required to adopt accrual accounting for OPEBs until 1993, but that it had chosen to adopt that method in 1991, thus rendering the accounting treatment of OPEB liabilities for 1991 and 1992 within the company's control and not subject to exogenous treatment. The Common Carrier Bureau again suspended the tariffs for a day, imposed an accounting order, and initiated a new investigation. *Bell Atlantic/NYNEX Investigation Order*, 10 FCC Rcd 1594 (CCB 1994).

In 1995, while the investigation was pending, the Commission separately adopted a rule, after a notice and comment rulemaking proceeding, that precluded exogenous treatment of OPEB accruals because they do not represent actual cash costs. *Price Cap Performance Review*, 10 FCC Rcd 8961, 9089-9095 (1995) (*1995 Price Cap Order*). That new rule had only prospective effect, however, *id*. 9095 ¶307, and thus by its terms did not govern Verizon's post-*Southwestern Bell* tariff filings. *2005 OPEBs Order* ¶31 (JA). As explained below, in the order on review the Commission approved of Verizon's attempt to recover 1991 and 1992 OPEB amounts as exogenous costs in its 1993 and 1994 tariffs. That decision is the subject of one of AT&T's complaints in this proceeding.

(2) Effect On Sharing Obligations.

SFAS-106 also affected carriers' rates through their sharing obligations, which are calculated on the basis of the LECs' rate bases. The rate base rules direct LECs to deduct specific liabilities from their rate bases. 47 C.F.R. § 65.830 (1992). In 1992, the Common Carrier Bureau issued a letter to the Responsible Accounting Officers (RAOs) of price cap regulatees directing them to deduct the amount of accrued OPEB liabilities from their rate bases. OPEBs, the Bureau ruled, "are similar to pension expenses ... and as such should be given the same rate base treatment." *RAO Letter 20*, 7 FCC Rcd 2872 (CCB 1992). At the time, the

Commission's rules explicitly required pension expenses (and a number of other specified items) to be deducted from the rate base, but did not mention OPEBs. 47 C.F.R. § 65.830 (1992). Carriers sought full Commission review of the staff's ruling, but complied with *RAO Letter 20* and excluded OPEBs from their rate bases while awaiting review.

Under the price cap sharing rules, a larger rate base will lead to lower reported earnings and thus to a smaller sharing obligation (if the company earns above a rate of return ceiling). A smaller sharing obligation potentially results in higher allowable rates the following year. *See* 47 C.F.R. § 61.45(d)(2) (1995). Conversely, exclusion of a particular asset from a carrier's rate base results in a higher rate of return, which can increase a carrier's sharing obligation and potentially produce rate reductions the following year. Thus, the rates an access customer such as AT&T pays can rise or fall on the basis of regulatory decisions directing a LEC to include or exclude an item from the LEC's rate base. The deduction of OPEBs liabilities from the LECs' rate bases produced smaller rate bases and correspondingly increased the LECs' rates of return, which led to larger sharing obligations – and correspondingly lower rates for access customers – in subsequent years.

In 1996, the Commission reversed and rescinded the Bureau's *RAO Letter 20*. *RAO 20 Rescission*, 11 FCC Rcd 2957 (1996). The Commission found that 47 C.F.R. § 65.830 "defines explicitly those items to be … excluded from the interstate rate base," and held that the staff could not properly order "any additional exclusions." *RAO 20 Rescission* ¶25. Because the specific items to be included in or excluded from the rate base were defined by a codified rule, the Commission in the same order began a rulemaking proceeding to consider whether to amend the list of items excluded from the rate base to include accrued OPEBs. The following year, the Commission amended the rule to require the deduction of OPEBs from the rate base going forward. *OPEBs Rate Base Order*, 12 FCC Rcd 2321 (1997). The rulemaking order also rejected a petition for reconsideration of the Commission's decision to rescind the *RAO 20 Letter*, reiterating that "the Bureau did not have the delegated authority to amend" the applicable rules. The Commission also rejected the contention that the Commission itself could amend those rules through an interpretation without notice and comment procedures. *OPEBs Rate Base Order* ¶28.

C. Carrier Response To The *RAO 20 Rescission Order*.

Shortly after the Commission rescinded *RAO Letter 20*, but before the Commission changed Rule 65.830 to exclude accrued OPEBs from the rate base, a number of LECs filed FCC forms to restate their rate bases for the years during which *RAO Letter 20* had been in effect. The LECs also filed tariffs that sought a one-time increase in the carriers' 1996 PCIs that was equal to the amount the carriers unlawfully had been required to share with their ratepayers as a result of their understated rate bases. They implemented the change in their PCIs by adding that amount as an "exogenous cost" in the formula set out in 47 C.F.R. § 61.45 (1992). The Common Carrier Bureau once again suspended the tariffs for a day, imposed an accounting order, and began an investigation. *1996 Tariff Order*, 11 FCC Rcd 7564 (CCB 1996). The issues raised in that investigation are the subject of the second aspect of AT&T's complaint in this case.

D. FCC Resolution Of The Ongoing Tariff Proceedings.

In the order on review, the Commission resolved the pending investigations involving both Verizon's implementation of the OPEB accrual accounting in 1991 and the rate base/sharing issues that arose in the aftermath of the *RAO 20 Rescission* order.

(1) Verizon 1992-1993 Tariff Issue.

The Commission allowed Verizon to give exogenous treatment to OPEBs liabilities booked prior to January 1, 1993, and found that Verizon had lawfully increased its PCIs in its 1993 and 1994 tariffs to reflect OPEB amounts accrued in 1991 and 1992. *2005 OPEBs Order* ¶¶18-31 (JA -).

The applicable price cap rules allowed exogenous treatment for "costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers." *2005 OPEBs Order* ¶20 (JA), citing *1990 Price Cap Order* ¶166. The question thus was whether in 1991 and 1992 accounting for OPEBs on an accrual basis was beyond Verizon's "control" within the meaning of the price cap rules in light of the ruling in the *SFAS-106 Order* that carriers implement accrual accounting "on or before" January 1, 1993.

The Commission found that Verizon's adoption of accrual accounting before the absolute deadline did not render the change in its accounting practices voluntary within the meaning of the control test. It is the Commission's longstanding policy to "confor[m] regulatory accounting for carriers to GAAP, including new FASB standards, unless the principle or practice conflicts with the Commission's regulatory objectives." *RAO 20 Rescission*, 11 FCC Rcd at 2958 ¶6. The Commission's rules require that a carrier's "records and accounts be adjusted to apply new accounting standards prescribed" by FASB. 47 C.F.R. § 32.16(a).

FASB adopted SFAS-106 in December 1990, and although the standard did not become mandatory until December 1992, FASB "affirmatively encouraged firms to put SFAS-106 in effect before that mandatory deadline." *2005 OPEBs Order* ¶24 (JA). The Commission approved the use of SFAS-106 in December 1991 and directed carriers to make the change "on or before January 1, 1993." *Ibid.*, citing *SFAS-106 Order*, 6 FCC Rcd at 7560 ¶6. Verizon implemented SFAS-106 immediately after the Commission approved the change, and "because its books of account were still open for calendar year 1991" at that time, Verizon made the change effective retroactive to January 1 of that year. *2005 OPEBs Order* ¶24 & n.86 (JA). "Verizon thus implemented SFAS-106 after its approval by the agency, in full compliance with the time frame prescribed in" the *SFAS-106 Order*. *2005 OPEBs Order* ¶24 (JA).

Under those circumstances, the Commission found, Verizon's implementation of SFAS-106 was not within Verizon's control within the meaning of the test for exogenous treatment under the Commission's price cap rules. Relying on this Court's holding that "an FASB change adopted by the Commission is not a change under control of the carrier, and, once mandated by the Commission, the change satisfies the control criterion," *Southwestern Bell*, 28 F.3d at 170, the Commission found that the question was "a matter of second impression," *2005 OPEBs Order* ¶27 (JA), essentially determined by the Court's earlier ruling. It did not matter, the Commission found, that Verizon had implemented SFAS-106 before the absolute deadline, because the Commission had directed the change to be made "on or before" January 1, 1993. "Where, as here, a governmental entity requires action 'on or before' a particular date, the act of complying 'before' the last permissible day is no less mandatory than the action of complying 'on' the expiration of the deadline." *Id.* ¶28 (JA).

The Commission rejected AT&T's claim that exogenous treatment of OPEBs liabilities should be denied because the accounting change did not result in any real cost change. In the *1995 Price Cap Order*, the Commission had found in the course of making new rules that OPEB liabilities would not qualify for exogenous treatment going forward because "SFAS-106 has had little or no effect on the opportunity costs and economic cost to LECs." *Id.*, 10 FCC Rcd at 9095 ¶307. But the Commission implemented that rulemaking change "on a prospective basis," and it explicitly ruled that the change "does not affect [the] pending investigations of exogenous cost claims based on OPEBs." *Ibid*. Rather, the "lawfulness [of the 1993 tariffs] will be judged under the rule in effect when the tariffs were filed." *Id*. ¶309. Thus, the Commission "reject[ed] AT&T's suggestion that we deny exogenous treatment for the OPEB costs at issue in this investigation on the grounds that they did not affect economic costs." *2005 OPEBs Order* ¶31 (JA -).

(2) Rate Base Issue.

The Commission found that the LECs were entitled to an exogenous increase in their 1996 PCIs to recover the sharing obligations they had incurred as a result of the staff's erroneous ruling directing the LECs to exclude accrued OPEBs amounts from the rate base. *2005 OPEBs Order* ¶¶32-56 (JA -).

First, the Commission reiterated its conclusion in the *RAO 20 Rescission* that its rules for calculating the rate base from 1993 to 1996 "required the LECs to include accrued OPEB costs in the interstate rate base." *2005 OPEBs Order* ¶42 (JA). Rule 65.830 "enumerates specific deductions from the rate base," but as it existed prior to 1997, the list of exclusions did not include OPEBS. *2005 OPEBs Order* ¶43 (JA). "[T]he fact that former section 65.830 expressly contained an explicit deduction for accrued pension costs, which are analogous to accrued OPEB liabilities, indicates strongly the Commission's intent that accrued OPEB liabilities should not be deducted from the rate base." *Ibid*. If the rule could have been interpreted to require the exclusion of OPEBs, the Commission found, there would have been no need to change it by notice-and-comment rulemaking. *Id.* ¶46 (JA).

As noted above, the carriers had factored the rate base adjustment into their PCI formulas as exogenous cost increases for 1996. Thus, having established that the LECs legitimately should have included the OPEB amounts in their rate bases for the relevant years, the Commission had to address whether the LECs were entitled to an exogenous increase in their 1996 rates to recover the revenue they had lost from 1992 to 1995 as a result of the improper exclusion from the rate base. AT&T, which had benefited from the staff's error, had raised two principal arguments against recovery: first, that 47 C.F.R. § 65.600(d)(2) prohibited making changes to the rate base more than 15 months after the end of the calendar year; and second, that 47 C.F.R. § 61.45(d) limited exogenous cost changes to "those cost changes that the Commission shall permit or require by rule, rule waiver, or declaratory ruling." *Ibid.* AT&T claimed that the latter rule would be violated by a PCI increase because, in the *1995 Price Cap Order*, the Commission specifically had prohibited exogenous treatment of liabilities that do not represent actual economic costs. *2005 OPEBs Order* ¶52 (JA).

The Commission "assume[d], but [did] not decide, that the LECs' retroactive adjustments are inconsistent with sections 65.600(d)(2) and 61.45(d)," but found it "to be in the public interest to grant waivers of these rules to the extent necessary to permit the LECs to restore … the accrued OPEB liabilities that the LECs deducted from their rate bases in compliance with the now vacated *RAO Letter 20*." *2005 OPEBs Order* ¶53 (JA). In essence, the Commission waived its rules in order to correct the effects of the staff's error.

With respect to Rule 65.600(d)(2), the Commission found that "in the specific circumstances of this case, it would be inequitable to enforce the [15-month] deadline." *2005 OPEBs Order* ¶54 (JA). The LECs "hardly could have been expected to file rate base adjustments reversing the effects of the *RAO Letter 20* before the Commission vacated that staff decision," and "it is unquestioned that the LECs filed their rate base adjustments in a prompt manner shortly after the Commission issued the *RAO Rescission Order*." *Ibid.* (JA).

With respect to Rule 61.45(d), the Commission found that, in the "unusual circumstances of this case …, the public interest is served by a waiver ... of the rule provision limiting exogenous cost adjustments to economic cost changes." *2005 OPEBs Order* ¶55 (JA). "Had the staff not erroneously directed the LECs to deduct [OPEB] liabilities …, the LECs would have included accrued OPEB liabilities in their rate bases in the years 1992 through 1995 without any need for any 'exogenous' cost adjustments." *Ibid.* The situation thus called for application of the equitable principle that "an agency has authority to 'undo … what was wrongfully done by virtue of [a legally erroneous] order.'" *Id.* ¶56 (JA), quoting *Southeastern Michigan Gas Co. v. FERC*, 133 F.3d 34, 42 (D.C. Cir. 1998). The Commission determined that the public interest required putting the LECs "in the position they would have been in had the error not been made." *2005 OPEBs Order* ¶56 (JA), quoting *Exxon Co. v. FERC*, 182 F.3d 30, 49 (D.C. Cir. 1992).

AT&T now challenges both aspects of the Commission's order.

SUMMARY OF ARGUMENT

1. The erroneous staff ruling in *RAO Letter 20* required the LECs to deduct OPEBs liabilities from their rate bases. That deduction made the rate bases smaller than they would have been under a proper interpretation of the Commission's rate base rules, which led to a corresponding increase in the LECs' sharing obligations for the years in which their rate bases were understated. Increased sharing obligations led to lower PCIs than would have been permissible in the absence of the staff error. In other words, the LECs earned less revenue than they would have if the staff had properly interpreted the rate base rules. Access customers such as AT&T, on the other hand, paid lower rates than they would have paid and thus reaped a substantial windfall as a result of the staff's error.

In the order on review, the Commission decided that it would serve the public interest to rectify the effects of the staff's error by restoring the parties to the positions they would have been in had the error not occurred. The Commission's action was thus a reasonable exercise in error correction, and the law is clear that when an agency commits legal error it has the equitable power to remediate the consequences and undo what was wrongfully done. *Southeastern Michigan Gas Co. v. FERC*, 133 F.3d 34, 42 (D.C. Cir. 1998); *Exxon Co. v. FERC*, 182 F.3d 30, 50 (D.C. Cir. 1999); *Verizon Tel. Cos. v. FCC*, 269 F.3d 1098, 1111 (D.C. Cir. 2001).

a. The Commission reasonably waived Rule 61.45(d) in order to restore the parties to their rightful positions. That rule limits exogenous cost treatment to those cost changes that the Commission permits or requires, and read in conjunction with the *1995 Price Caps Order*, the rule would arguably have prohibited the LECs from being made whole by barring exogenous recovery of foregone revenue. AT&T claims that the Commission failed to explain why the waiver serves the public interest, Br. 25, but that assertion ignores the Commission's specific and convincing equitable rationale. All waivers require the compromise of a general policy in order to accommodate specific and unexpected circumstances, and here the Commission reasonably found that fairness and equity outweighed the policy that prohibits exogenous treatment of OPEBs liabilities.

AT&T also argues that the equitable considerations on which the Commission relied were insubstantial. The claim is that the LECs were not truly victims of agency error – and there are accordingly no equities on the LECs' side – because the staff's error in *RAO Letter 20* was merely a procedural error and not a substantive one. Br. 27-30. The Commission correctly determined, however, that the *RAO 20 Rescission Order* "decided *as a matter of substantive law* that the staff had erred." *2005 OPEBs Order* ¶46 (JA) (emphasis added).

The Commission reached that conclusion on the ground that, prior to 1997, the FCC rules that define the rate base and that specify the particular balance sheet items that must be deducted from the rate base did not list OPEBs liabilities as one of the deductions, even though they listed similar pension expenses. The *RAO 20 Rescission* order reversed the staff's directive to deduct OPEBs liabilities from the rate base because the rule did not specify OPEBs as one of the listed deductions. In the absence of an express requirement that OPEBs be deducted, the pre-1997 rule *required* the inclusion of OPEBs liabilities in the rate base (a matter AT&T does not challenge). The Commission could change that rule only by notice-and-comment rulemaking (a process that the Commission completed in 1997). When the staff had earlier ordered deduction of OPEBs from the rate base, it accordingly erred as a matter of substance, not procedure. Under the law in effect at the time, the LECs had a right to include OPEBs liabilities in their rate bases, and to have their sharing obligations calculated on the basis of correctly determined rate bases.

b. The same equitable considerations justify the Commission's waiver of 47 C.F.R. § 65.600(d)(2), which is a 15-month statute of limitations on corrections to a carrier's rate base. The rule would have prohibited the LECs from correcting the effects of the staff's error and accordingly could have barred recovery of their excess sharing amounts. The Commission reasonably decided to waive the rule because equitable tolling of a limitation period is a traditional method of allowing a party to overcome the effects of a deadline missed through no fault of that party. Equitable tolling applied here because the LECs were prohibited by *RAO Letter 20* from correcting their rate bases within the allowed time.

AT&T's arguments to the contrary are unavailing. Although the FCC changed its rules prospectively in 1997 to require deduction of OPEBs liabilities from the rate base, that rule was not in effect during the periods covered by the waiver. Thus, there is no conflict between the rule waiver and the subsequently imposed policy. The claim that *RAO Letter 20* was correct on the merits is wrong for the reasons stated above. AT&T's claim that the FCC would have changed its rules earlier had it realized the error in *RAO Letter 20* earlier is pure speculation that cannot support AT&T's burden to show that the Commission abused its discretion.

2. AT&T is wrong that the Commission has some kind of free floating, overriding duty to address the justness and reasonableness of the LECs rates under 47 U.S.C. § 201(b) beyond the scope of the issues that the Commission itself designated for investigation. Under 47 U.S.C. § 204(a), carriers are entitled to notice of the particular tariff matters the Commission proposes to investigate; here, the Commission informed the LECs that it would investigate their compliance with the existing rules governing the treatment of OPEBs. AT&T may not require the Commission to expand the scope of the investigation beyond the matters expressly designated by the Commission. In any case, there is no reason to believe that rates determined in accordance with applicable price cap rules will be unjust or unreasonable.

Even if AT&T could force an expansion of the issues as a general matter, it may not do so here because it did not raise the claim at the proper time. The Commission created a specific rule of procedure for this investigation that required the parties to set forth all of their arguments in their opening comments. AT&T did not raise § 201(b) in its initial comments, but brought up the matter only in an ex parte presentation filed some time later. Under the special procedural rule of this investigation, AT&T waived its § 201(b) argument.

3. The Commission properly allowed Verizon exogenous treatment of its OPEB liabilities booked in 1991 and 1992. The agency reasonably determined that the change from cash to accrual accounting was not within Verizon's "control" within the meaning of the *1990*

Price Cap Order and that SFAS-106 was "effective" within the meaning of that order at the time Verizon implemented it.

a. Exogenous costs are those that are "triggered by administrative … action beyond the control of the carriers." *1990 Price Cap Order* ¶166. The Commission's regulations provide that a LEC's regulatory accounts "shall be adjusted to apply new accounting standards prescribed" by FASB. 47 C.F.R. § 32.16(a). In the *1990 Price Cap Order*, the Commission specifically listed a change in accounting practices as an example of a matter beyond a carrier's control. 5 FCC Rcd at 6807 ¶166. In *Southwestern Bell*, this Court similarly found that "an FASB change adopted by the Commission is not a change under control of the carrier." 28 F.3d at 170. The Commission thus properly found that an accounting change implemented by FASB and approved by the Commission was not within the carriers' control within the meaning of the control test set forth in the *1990 Price Cap Order* and is eligible for exogenous treatment.

AT&T nevertheless contends that because Verizon had some discretion over the timing of its switch to accrual accounting, the matter was "entirely within its control." Br. 35. But that argument relies on an understanding of the control test that is much broader than the Commission's reasonable application of that test. The Commission has consistently recognized that an administratively mandated accounting change, unlike a general operating cost, is not a matter that a carrier can control. As such, costs imposed by a regulator are categorically beyond the carrier's control, even if the carrier has some degree of choice as to timing. The control test asks not *when* a cost change takes place but *why* it takes place, and if it takes place as a result of a regulatory directive, it is not within the carrier's control. *Southwestern Bell*, which found that changes in GAAP "become mandatory … after the Commission f[inds] them … consistent with the agency's regulatory objectives," 28 F.3d at 168, supports – perhaps even requires – the agency's understanding of the control test.

b. The Commission also reasonably found that SFAS-106 was "effective" when Verizon switched to accrual accounting. The term "effective" is subject to a number of plausible interpretations, depending on the context. AT&T claims that it means when FASB makes a rule effective. But the Commission properly read the term, in the context of the price cap program, to mean when the Commission itself permits or requires the implementation of an accounting change. The Commission directed carriers to put SFAS-106 into effect "on or before January 1, 1993," and the change to accrual accounting accordingly was effective during 1991 and 1992 when Verizon implemented that practice.

That interpretation is compatible with the common understanding of the word effective: the agency that directly regulates the carrier has required the change to be placed in effect. It is also consistent with the *1990 Price Cap Order*, where the Commission drew a distinction between when FASB has "actually approved" a change in accounting practices and when the change "become[s] effective" for purposes of exogenous treatment. *1990 Price Cap Order* ¶168. There, the Commission relied on an earlier staff order holding that "exogenous costs can be either cost changes resulting from a change in [the FCC's] accounting rules *or in any Commission-approved change in GAAP*." *American Telephone and Telegraph Co.*, 5 FCC Rcd 3680 (CCB 1990) (emphasis added). For that reason, the *1990 Price Cap Order* described the effectiveness test as one "intended to reflect changes in costs that have occurred, not anticipated cost changes." *1990 Price Cap Order* ¶168. The "effective" test that the Commission implemented in reliance on the AT&T decision thus may properly include changes in accounting practices that have been authorized by the Commission even if they have not yet been made "effective" by FASB for more general accounting purposes.

ARGUMENT

I. STANDARD OF REVIEW.

Under the Administrative Procedure Act, the Court must affirm an agency's determinations unless they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). That standard is highly deferential; the Court "presume[s] the validity of the Commission's action and will not intervene unless the Commission failed to consider relevant factors or made a manifest error in judgment." *Consumer Electronics Ass'n v. FCC*, 347 F.3d 291, 300 (D.C. Cir. 2003); *see Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 416 (1971) (agency action is arbitrary and capricious if the agency has committed a "clear error of judgment"). That standard applies to review of an FCC decision to waive its rules. *AT&T Wireless Services, Inc. v. FCC*, 270 F.3d 959 (D.C. Cir. 2001).

To the degree that this matter involves the Commission's interpretations of its own orders and rules, "an agency's construction of its own regulations is entitled to substantial deference." *Lyng v. Payne*, 476 U.S. 926, 939 (1986). The reviewing court must give effect to the agency's interpretation so long as it is reasonable; in other words, whether it "sensibly conforms to the purpose and wording of the regulations." *Northern Indiana Pub. Serv. Co. v. Porter County Chapter of Izaak Walton League of America, Inc.*, 423 U.S. 12, 15 (1975). Thus, the Court gives "controlling weight to the Commission's interpretation of its own regulations unless it is plainly erroneous or inconsistent with the regulation." *Communications Vending Corp. of Arizona, Inc. v. FCC*, 365 F.3d 1064, 1069 (D.C. Cir. 2004) (quotation marks and citation omitted). Deference to the expert agency's interpretation is particularly warranted where, as here, "the regulation concerns a complex and highly technical [regulatory] program, in which the identification and classification of relevant criteria necessarily require significant expertise and entail the exercise of judgment grounded in policy concerns." *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994) (internal quotation marks omitted).

II. THE COMMISSION REASONABLY WAIVED RULES 65.600(d)(2) AND 61.45(d) FOR THE 1996 TARIFFS.

The Commission's rules allow it "at any time" to waive "any provision of the rules" on a showing of "good cause." 47 C.F.R. § 1.3. The agency may waive a rule on its own motion or in response to a request from a carrier. *Ibid*. Waivers are justified if "particular facts would make strict compliance inconsistent with the public interest." *Northeast Cellular Tel. Co. v. FCC*, 897 F.2d 1164, 1166 (D.C. Cir. 1990). The Court has recognized that "an agency's discretion to proceed in difficult areas through general rules is intimately linked to the existence of a safety valve procedure for consideration of an application for exemption based on special circumstances." *WAIT Radio v. FCC*, 418 F.2d 1153, 1157 (D.C. Cir. 1969), *cert. denied*, 409 U.S. 1027 (1972). *See also National Rural Telecomm.*, 988 F2d at 181 (waiver is "an appropriate method of curtailing the inevitable excesses of the agency's general rule"). The Commission reasonably exercised its waiver authority with respect to both rules at issue, and the Court should exercise its usual deference in assessing the Commission's decision. *Office of Communication of United Church of Christ v. FCC*, 911 F.2d 803, 812 (D.C. Cir. 1990) (upholding the FCC's grant of a waiver "[g]iven the deference due the agency in matters of this sort")

A. The Commission Reasonably Waived Rule 61.45(d).

Rule 61.45(d) limits exogenous cost increases "to those cost changes that the Commission shall permit or require by rule, rule waiver, or declaratory ruling." 47 C.F.R. § 61.45(d). In the *1995 Price Cap Order*, the Commission determined after a rulemaking proceeding that increased booked costs, such as OPEB accruals, that result from changes in accounting practices but do not reflect actual economic costs, would from that point on be ineligible for exogenous treatment. *Id.*, 10 FCC Rcd at 9089-9097. That ruling, combined with § 61.45(d), meant that, after 1995, LECs could no longer get exogenous treatment of accrued, but not yet paid, OPEB expenses.

Assuming, but not deciding, that the rule would bar the particular liabilities at issue here, even though they were booked for years prior to the 1995 rulemaking, *2005 OPEB Order* ¶53 (JA),[1] the Commission found that in "the unusual circumstances of this case" it would serve the public interest to waive the rule and allow the LECs "to rectify the effects of the vacated *RAO Letter 20*." *Id.* ¶55 (JA). Because the LECs complied with the staff's erroneous *RAO Letter 20*, their rate bases had been artificially depressed, and the LECs thus had incurred sharing obligations that they would not have incurred if the staff had correctly interpreted the Commission's regulations. Those sharing obligations had led to rates – paid by long distance carriers, including petitioner – that were lower than they otherwise would have been but for the staff's improper action. In other words, from 1992 until 1995, AT&T and other long distance carriers had paid less money, at the expense of the LECs, than they would have paid in the absence of agency error.

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[1] Given that the LECs lawfully could have collected more money but for the staff's error, the costs at issue here could have been considered actual economic costs, and not simply non-economic accounting costs.

In such circumstances an agency has the authority to "undo … what was wrongfully done," *Southeastern Michigan Gas Co. v. FERC*, 133 F.3d at 42, citing *United Gas Improvement Co. v. Callery Properties, Inc.*, 382 U.S. 223, 229 (1965), and remediate its own mistake. "There is … a strong equitable presumption in favor of retroactivity that would make the parties whole. …'[W]hen the Commission commits legal error, the proper remedy is one that puts the parties in the position they would have been in had the error not been made.'" *Exxon Co. v. FERC*, 182 F.3d at 50, quoting *Public Utilities Comm'n of the State of California v. FERC*, 988 F.2d 154, 168 (D.C. Cir. 1993). Considerations of equity likewise apply to rule waivers. *WAIT Radio,* 418 F.2d at 1159; *Bachow Communications, Inc. v. FCC*, 237 F.3d 683, 688 (D.C. Cir. 2001) (it is "manifestly within the Commission's discretion" to take account of equitable considerations in deciding whether to grant waiver).

The Commission's action here thus "was largely an exercise in error correction." *Verizon Tel. Cos. v. FCC*, 269 F.3d 1098, 1111 (D.C. Cir. 2001). The Commission reasonably exercised its equitable authority when it restored the parties to the positions in which they would have been if the agency error had not occurred. Waiving the rule against exogenous treatment of non-economic accounting changes "advance[s] the public interest by permitting the LECs to correct the errors arising solely from their compliance with the staff's legally deficient order." *2005 OPEBs Order* ¶56 (JA). The Commission has followed that practice in similar cases of legal error. *Communications Vending Corp. of Arizona v. Citizens Communications Co.*, 17 FCC Rcd 24201, 24215 ¶36 (2002), *aff'd*, 365 F.3d 1064 (D.C. Cir. 2004); *Verizon Tel. Cos.*, 269 F.3d at 1111. In waiving the rule, the Commission struck a reasonable balance between the competing policies of prohibiting exogenous treatment of non-economic costs and serving equity by not requiring a private party to bear the brunt of FCC error. The Court has in similar cases "deferred to [an agency's] balancing of the equities, recognizing that the difficult problem of balancing competing equities and interests has been given by Congress to the Commission with full knowledge that this judgment requires a great deal of discretion." *PUC of California*, 988 F.2d at 168 (quotations and citations omitted); *see also Las Cruces TV Cable v. FCC*, 645 F.2d 1041, 1047 (D.C. Cir. 1981) (in justifying a refund, an agency need only show that it "considered relevant factors and ... struck a reasonable accommodation among them"). The Commission plainly did not "act out of unbridled discretion or whim" in granting the waiver, *WAIT Radio*, 418 F.2d at 1159, but "clearly state[d] in the record its reasons" for the grant. *Ibid.*

AT&T nevertheless claims that the Commission acted arbitrarily because it "did not (and could not) explain why this waiver serves the public interest." Br. 25. But, as described above, the Commission gave a specific and convincing reason for its action – one that AT&T ignores. Instead, AT&T asks the Court to examine only one side of the policy balance that the Commission struck: it describes the policies that motivated the Commission to deny exogenous treatment to accrued OPEB liabilities, Br. 22-24, 26-27, and argues that "[t]here are no offsetting public interest benefits." Br. 26. Such an approach ignores the very nature of a waiver, which necessarily involves the compromise of a general policy in order to accommodate the specific needs of unanticipated circumstances. Here, the Commission decided that fairness and equity outweighed the policy that prohibits exogenous treatment of non-economic costs (a policy that had not been set forth until after the underlying OPEB costs at issue here arose).

AT&T admits in its next argument that the Commission gave an explanation for its action, but contends that the explanation was faulty. The claim is that it was "a non-sequitur" to waive § 61.45(d) to give the LECs an equitable opportunity to rectify the effects of *RAO Letter 20* on the LECs' rate bases because § 61.45(d) does not govern rate bases. Br. 27. That claim ignores the Commission's point that because of the erroneous staff directive to include OPEBs in the rate base, the LECs' reported earnings were higher than they otherwise would have been, resulting in higher sharing obligations, and thus lower rates, the following years. It is not surprising that AT&T omits mention of its receipt of a multi-million-dollar sharing windfall, but that was the crucial factor driving the Commission's decision and justifying its policy balance. If § 61.45(d), which governs exogenous treatment of cost increases, stood in the way of restoring the parties to the positions they would have been in but for the agency's error, it was appropriate to waive that rule.

Finally, AT&T implies that the waiver was arbitrary because the equitable considerations on which the Commission based its decision lacked substance. AT&T claims that the Commission rescinded *RAO Letter 20* because of a procedural error, "*not* because [of] … any substantive merit" in the LECs' position. Br. 27 (emphasis in original). Thus, the argument goes, "given that the FCC has expressly recognized that the *RAO 20 Letter* was correct on the merits, nothing was 'wrongfully done' in forbidding LECs to include" OPEBs in their rate bases and there accordingly are no equities on the LECs' side. Br. 30. That claim is wrong both because it misreads the Commission's decision rescinding *RAO Letter 20* and because it confuses the Commission's policy preferences with the legal requirements expressed in the rules. In fact, the *RAO 20 Rescission Order* "decided *as a matter of substantive law* that the staff had erred" and that the law *required* the LECs to include OPEBs in their rate bases prior to 1997, even if the law that the staff had violated no longer seemed to reflect the best policy. *2005 OPEBs Order* ¶46 (JA) (emphasis added).

The question before the staff at the time of *RAO Letter 20* was whether 47 C.F.R. § 65.830 required or permitted the deduction of OPEBs liabilities from the rate base. *2005*

OPEBs Order ¶43 (JA). The Commission found that "[n]othing in the language of the pre-1997 version of section 65.830 suggests that accrued OPEB liabilities are among the expenses that are to be deducted from the rate base." *2005 OPEBs Order* ¶43 (JA). Rather, the express inclusion of pension benefits in the list of deductions indicated to the contrary. *Ibid.* Because the rules "define[d] explicitly those items to be … excluded from" the rate base, *ibid.*, quoting *RAO 20 Rescission Order* ¶25, "the pre-1997 rule did not permit the LECs to deduct accrued OPEB costs from the rate base." *2005 OPEBs Order* ¶48 (JA). In other words, prior to the 1997 change in the rule, LECs were *required* to include OPEBs – a rule that the Commission could change only by a notice-and-comment rulemaking proceeding. *Id.* ¶46 (JA). AT&T does not argue otherwise.

Thus, until the Commission completed such a proceeding in 1997, the FCC's rules required the LECs to include OPEBs in their rate bases. Had the Commission found otherwise, it would have violated the principle – relied on by AT&T itself (Br. 24 n.19) – that "[a]n agency is required to follow its own regulations." *Cherokee Nation of Oklahoma v. Babbitt*, 117 F.3d 1489, 1499 (D.C. Cir. 1997). Indeed, failure to follow the rules – notwithstanding a contrary policy preference – was the very ground on which this Court reversed the FCC's decision to deny exogenous cost treatment to OPEBs in *Southwestern Bell*, 28 F.3d at 169. The Commission rescinded *RAO Letter 20* not because of a procedural error, but because the staff's ruling failed to comport with the regulations as written.[2] That was the essential ground for the Commission's denial of reconsideration in the *RAO 20 Rescission Order*. AT&T has not shown a clear error of judgment that would justify reversal.

[2] For that reason, AT&T has incorrectly relied (Br. 30) on the finding in *PUC of California*, 988 F.2d at 163, that where an order is reversed on non-substantive grounds, the agency need not "undo what was wrongfully done."

AT&T's argument also confuses the question of the correct *policy* outcome with the correct *legal* outcome when it argues that *RAO Letter 20* was substantively correct. To be sure, in the *RAO 20 Rescission Order*, the Commission "was not unsympathetic to the policy rationale underlying *RAO Letter 20*." *2005 OPEBs Order* ¶46 (JA). Indeed, the Commission ultimately amended its rule to implement the very policy that the staff had attempted to read into the original rule. But it is clear that the regulations prior to 1987 neither required nor allowed exclusion of OPEBs liabilities from the rate base, a matter AT&T does not challenge. Nor is it the case, as AT&T suggests, that non-investor-supplied capital may never properly be included in the rate base. Br. 2, 8, 28. The Commission expressly rejected such an approach in 1987 when it declined to adopt a proposed rule to that effect. *2005 OPEBs Order* ¶44 (JA), citing *Components of the Rate Base*, 3 FCC Rcd 269, 285 (1987). Thus, policy considerations aside, under the established *law*, the LECs had a right under the rules to have their sharing obligations calculated according to the rate base rules in effect at the time. The Commission properly took that right into account in weighing the equities.[3]

B. The Commission Reasonably Waived Rule 65.600(d)(2).

Rule 65.600(d)(2) requires carriers to "file with the Commission within fifteen months after the end of each calendar year" any corrections or modifications to their rate base reports. 47 C.F.R. § 65.600(d)(2). That rule operates, in other words, as a rule of limitation on the time for a carrier to restate its rate base. The Commission found that, "in the specific circumstances

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[3] AT&T claims (Br. 24) that the FCC impermissibly "departed … without explanation" from the rule that limits exogenous cost increases to those that "the Commission shall permit or require by … rule waiver." 47 C.F.R. § 61.45(d). That rule says nothing about the timing of such a waiver, nor does it require a waiver request to be made in a tariff filing. The Commission satisfied the rule when it granted the waivers in the *2005 OPEBs Order*.

of this case, it would be inequitable to enforce the deadline in section 65.600(d)(2)" because the LECs "hardly could have been expected to file rate base adjustments … before the Commission vacated" *RAO Letter 20*. *2005 OPEBs Order* ¶55 (JA). That determination was reasonable.

In effect, the Commission determined that the 15-month deadline had been equitably tolled because its own error had prevented the LECs from complying with the deadline. "[E]quitable tolling is a traditional feature of the procedural landscape," *Chung v. United States Dept. of Justice*, 333 F.3d 273, 276 (D.C. Cir. 2003), to which "[t]ime requirements … are customarily subject," *Irwin v. Department of Veterans Affairs*, 498 U.S. 89, 95 (1990). Indeed, the situation at hand is equivalent to one in which the Supreme Court has expressly recognized equitable tolling is appropriate, where a litigant missed a filing deadline not through its own fault, but because of the actions of its adversary. *Id*. at 96. The staff's error had that effect on the LECs' ability to meet the filing deadline. This is not a situation in which a party has "failed to exercise due diligence in preserving his legal rights." *Ibid*. To the contrary, the LECs timely challenged the staff's erroneous ruling, and they "filed their rate base adjustments in a prompt manner shortly after the Commission issued the *RAO Rescission Order*." *2005 OPEBs Order* ¶55 (JA).

AT&T's claim that the waiver was inconsistent with the "FCC's own recognition that the rate base should include only investor-supplied funds," Br. 28, fails because it confuses the FCC's subsequent policy preference with the actual rate base rules that were in effect during the relevant time period. Those rules, the meaning of which AT&T does not dispute, required LECs to include OPEBs in their rate bases, as described above. Indeed, the Commission in 1987 declined to adopt a rule that would have excluded all zero-cost funds from the rate base. *2005 OPEBs Order* ¶44 (JA). The claim that *RAO Letter 20* "was correct on the merits," Br. 30, is likewise wrong for the reasons discussed above. Finally, AT&T contends that if the FCC had recognized earlier that its rules required inclusion of OPEBs liabilities in the rate base it "would have issued a procedurally proper ruling [correcting the matter] … as early as 1992." Br. 29. That contention is pure speculation that cannot support AT&T's burden to prove that the Commission abused its discretion here.

III. AT&T'S CLAIM THAT THE COMMISSION VIOLATED SECTION 201(b) IS BASELESS.

AT&T broadly claims that, regardless of the LECs' compliance with the FCC's rules, the agency in investigating the tariffs had a separate "overriding and fundamental obligation to assure that rates are 'just and reasonable' as required by § 201(b) of the Communications Act," and that the agency "unlawfully ignored" that obligation. Br. 31. That argument fails because it ignores the parameters of this tariff investigation specified by the Commission. Moreover, AT&T has waived any argument about § 201(b).

A. The Commission Properly Confined Its Inquiry To The Specific Issues Designated For Investigation.

Section 204(a) of the Communications Act, 47 U.S.C. § 204(a), governs tariff investigations and provides that when the Commission investigates a tariff it must provide the carrier(s) with notice of the issues under investigation: the agency must "delive[r] to the carrier or carriers affected [by the hearing order] a statement in writing of its reasons" for the investigation. That statement of reasons defines the scope of the investigation, to satisfy due process considerations. The Commission may decline to address other matters raised by the parties but not designated for investigation. *See*, *e.g.*, *AT&T Communications, Revisions to Tariff 12*, 6 FCC Rcd 7039, 7040 n.4 (1991). In this case, the Common Carrier Bureau's order suspending the LECs' 1996 tariffs for investigation provided the LECs with notice that the

Commission would assess several specific matters: "The LECs' rate base treatment of OPEBs raises a substantial question of lawfulness *under existing rules* that warrants investigation. Further, we believe that the Commission after a full record [is developed] should "determine *the correct application of our rules* to the LECs' treatment of OPEBs in their 1996 [tariff] filings." *1996 Tariff Order*, 11 FCC Rcd at 7573 ¶19 (emphasis added).[4] Thus, the investigation was limited to the LECs' compliance with the Commission's existing rules governing treatment of OPEBs. The LECs were not informed that they might face refund liability under § 204 *even if* they demonstrated full compliance with the specified Commission rules.

In those circumstances, AT&T may not now require the Commission to expand the scope of the tariff investigation beyond the rule compliance issues noticed pursuant to § 204(a). The resolution of issues not designated for investigation would contravene the notice requirement of § 204(a). Moreover, the FCC may "conduct its proceedings in such manner as will best conduce to the proper dispatch of business and to the ends of justice," 47 U.S.C. § 154(j), and the Supreme Court "has interpreted that provision as explicitly and by implication delegating to the Commission power to resolve subordinate questions of procedure such as the scope of the inquiry." *FCC v. Schreiber*, 381 U.S. 279, 289 (1965) (citations and quotation marks omitted). In short, the Commission has considerable discretion to conduct investigations on its own terms as it sees fit, consistent with due process requirements, and a participant in a Commission

[4] The FCC had earlier designated other specific issues for hearing, all of which were limited to the proper treatment of OPEBs liabilities. *1993 Annual Access Tariff Filings*, Order Designating Issues For Investigation, 10 FCC Rcd 11804, 11812-11815 (CCB 1995). Similarly, in a staff order reviving the investigation after it had been accidentally closed, the staff made clear that the only issue open for investigation were Verizon's 1992 and 1992 tariffs and the rate base treatment of OPEBs. *Stale or Moot Docketed Proceedings*, Order, Notice and Erratum, 18 FCC Rcd 2550, 2551 ¶4 (WCB 2003).

investigation may not require the agency to expand the scope of the proceedings to include matters that go beyond the matters the Commission has designated for investigation. AT&T is therefore wrong that the Commission in the tariff investigation ignored some kind of free-floating duty to assure that rates are just and reasonable, notwithstanding the LECs' compliance with the rules. Br. 31. If AT&T believed that the rates were not reasonable outside of the LECs' compliance with the rules, it could have filed a complaint pursuant to 47 U.S.C. § 208 raising the matter itself.[5]

That said, there is no reason to believe that the rates at issue here are not just or reasonable. The Commission instituted a price cap regime specifically to produce rates that are just and reasonable. Under the price cap approach, when a carrier sets rates that were determined according to the rules specified by the Commission under the price cap formula, those rates are presumptively just and reasonable. *1990 Price Cap Order* ¶12 (tariffs that comply with the price cap rules are entitled to "a presumption of lawfulness"). Here, as the Commission found, the LECs' rates were produced in compliance with the Commission's price cap and rate base rules,

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[5] *AT&T v. FCC*, 978 F.2d 727, 732-733 (D.C. Cir. 1992), relied on by AT&T (Br. 32) is not to the contrary. That case involved a complaint filed pursuant to § 208 in which the complainant established the terms of the proceeding, and it raised a challenge to the relevant legal provision. The Court found that it was error "for the agency to dismiss AT&T's complaint … without deciding the question of law it presented." *Id*. at 729. *See id*. at 732 ("When presented with AT&T's complaint, the Commission had an obligation to answer the questions it raised."). The Court did not "think the FCC had any alternative but to confront the issue" presented in the complaint. *Ibid*. Moreover, the Court considered the rule at issue to be facially invalid, *id*. at 731, 733, which is not the case here.

and reasonable Commission waivers. There is no good reason to question the justness and reasonableness of rates produced in accordance with the rules.[6]

AT&T is wrong that the LEC rates at issue here are in fact unjust and unreasonable because, beginning in 1995, the Commission chose not to allow exogenous treatment of OPEB liabilities going forward. Br. 32-33. The Commission has never held that exogenous treatment of OPEBs is unjust and unreasonable – indeed, it allowed such treatment prior to 1995. *See MCI Telecommunications Corp. v. US West*, 15 FCC Rcd 9328, 9334 ¶14 (2000) (where carriers established a charge pursuant to established rule, they are "entitled to rely on [the rule] in establishing their charges," and complainant cannot show that charge is unjust and unreasonable by pointing to changes that have taken place since the rule was implemented). Moreover, when the Commission decided in 1995 to disallow exogenous treatment of OPEBs, it expressly directed that its ruling would operate only prospectively. *1995 Price Cap Order* ¶309. Indeed, to the degree that AT&T seeks in a tariff review proceeding to impose on the LECs' 1992-1995 rates a rule change the Commission adopted in 1995, Br. 31-32, that outcome poses issues of unfair retroactivity by changing the past legal consequences of past actions. *See Bowen v. Georgetown University Hospital*, 488 U.S. 204, 219 (1988) (Scalia, J., concurring).

Finally, AT&T has failed to specify any means by which the FCC should determine whether the rates here are just and reasonable. The Commission found after a full investigation

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[6] Under the price cap methodology, "the extent to which the rates and other terms of [a LEC's] tariff are just and reasonable could only be determined with reference to price cap regulation." *Southwestern Bell Tel. Co. Application for Review*, 8 FCC Rcd 2261 ¶7 n.9 (1993). When a carrier "compl[ies] fully with price cap requirements," the "overall earnings produced by [its] rates … will be just and reasonable." *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637 ¶202 (1992). Indeed, challenges "based upon total interstate earnings" are "foreclosed by price cap regulation." *Id.* at ¶153 n.211.

that the LECs' rates were legitimately established pursuant to existing regulations and well-considered waivers. AT&T has provided no reason to require the Commission to follow up its price cap investigation with yet another investigation to examine, according to some undetermined standard, whether rates that satisfy price cap rules are indeed just and reasonable.

B. AT&T Has Waived Any Claim Under § 201(b).

For the foregoing reasons, the Commission properly confined its inquiry to the specific issues set for investigation and did not embark on a separate examination of the LECs' rates outside the LECs' compliance with the relevant rules. If the Court were to conclude, however, that AT&T was entitled to expand the scope of the Commission's inquiry, AT&T has waived its argument that the LEC tariffs violate § 201(b) by failing to raise it at the proper time. "Simple fairness to those who are engaged in the tasks of administration, and to litigants, requires as a general rule that courts should not topple over administrative decisions unless the administrative body not only has erred but has erred *against objection made at the time appropriate under its practice*." *United States v. L.A. Tucker Truck Lines, Inc.*, 344 U.S. 33, 37 (1952) (emphasis added). That rule bars AT&T's § 201(b) argument.

The tariff investigations that were resolved in the *2005 OPEBs Order* began in 1993 and proceeded fitfully from that point. In February 2003, under threat by AT&T to seek a writ of mandamus, *see* Br. 16, the Commission staff issued an order that required the parties to refresh the record. That order directed the parties to "state in full their arguments on [the] issues." *Stale or Moot Docketed Proceedings*, 18 FCC Rcd 2550, 2558 ¶22 (WCB 2003). The Commission thus implemented a particular rule of practice in this proceeding that required the parties to assert *all of their arguments* in their opening pleadings. Yet AT&T did not raise a separate § 201(b) claim in its initial pleading; rather, it argued the case under the price cap rules and procedures.

Only belatedly did AT&T raise its separate § 201(b) claim for the first time in ex parte presentations on or about June 2004, more than year after opening comments were filed. Given the time pressure under which the Commission was operating by then due to AT&T's threatened and actual mandamus litigation, the procedural rule requiring all arguments to be raised at the outset was especially important. Indeed, it appears from the citations to the record that the Commission relied almost exclusively on the opening pleadings – as it had intended in issuing the February 2003 order requiring that the record be refreshed. The Commission made only a handful of citations to any ex parte pleadings (and then, almost entirely for factual matters, not for completely new legal arguments). "[E]xhaustion principles normally require compliance with the agency's procedural rules (and rulings)." *Northwestern Indiana Telephone Co., Inc. v. FCC*, 872 F.2d 465, 470-471 (D.C. Cir. 1989). Here, the Commission implemented a particular procedural requirement with which AT&T did not comply and that now bars its late-raised argument. At the very least, AT&T's flouting of the procedural requirements here fully justifies any failure by the Commission to address AT&T's argument directly.

IV. THE COMMISSION PROPERLY ALLOWED VERIZON EXOGENOUS TREATMENT OF OPEB LIABILITIES BOOKED IN 1991 AND 1992.

The Commission found that that Verizon's 1991 change from cash accounting to accrual accounting for OPEBs was not within Verizon's "control" within the meaning of the control test set forth in the *1990 Price Cap Order* and that exogenous treatment of 1991 and 1992 OPEBs liabilities was proper. AT&T complains that the Commission was wrong on both counts.

A. The Commission Reasonably Determined that The Accounting Change Was Not Within Verizon's "Control."

In the *1990 Price Cap Order*, the Commission defined exogenous costs as those "that are triggered by administrative, legislative or judicial action beyond the control of the carriers." 5 FCC Rcd at 6807 ¶166. As a specific example of a matter beyond a carrier's control, the Commission stated that "[c]hanges in LEC costs that are caused by changes in ... the Uniform System of Accounts (USOA), will be considered exogenous. … [S]uch changes are imposed by this Commission and are outside the control of carriers." *Id*. at 6807 ¶168. The regulations that govern the USOA provide in turn that a LEC's regulatory accounts "shall be adjusted to apply new accounting standards prescribed" by FASB. 47 C.F.R. § 32.16(a). In *Southwestern Bell*, the Court described the arrangement to mean that "GAAP changes would originate in the FASB and would become mandatory in the pertinent sense only after the Commission found them … consistent with the agency's regulatory objectives." 28 F.3d at 168. The critical point, the Court held, is that "the Commission's mandate brings about the change and demonstrates that the carriers lacked control." *Ibid*. In short, "an FASB change adopted by the Commission is not a change under control of the carrier." *Id*. at 170.

Under that framework, the Commission properly found that the question whether costs associated with the implementation of SFAS-106 are within a carrier's control "is a matter of second impression" effectively resolved by those prior rulings. *2005 OPEBs Order* ¶27 (JA). Under the *1990 Price Cap Order*, the Commission's rules, and *Southwestern Bell*, the change to accrual accounting for OPEBs "was beyond the carrier's control … because that GAAP change had been adopted by the FASB and mandated by the Commission." *2005 OPEBs Order* ¶27 (JA). That reasoning was sound; under the Commission's rules, a carrier's accounting practices "*shall be adjusted*" to reflect changes in GAAP, once the Commission has determined that the change is consistent with its regulatory principles. 47 C.F.R. § 32.16(a) (emphasis added). The Commission determined in December 1991 that SFAS-106 "will not conflict with the Commission's regulatory objectives," and it authorized carriers to implement the new practice "on or before January 1, 1993." *SFAS-106 Order*, 6 FCC Rcd at 7560 ¶3. Carriers were thus required to adopt the new practice even though they had some discretion as to whether to do so before the January 1, 1993, deadline. As such, "the Commission's mandate br[ought] about the change." *Southwestern Bell*, 28 F.3d at 168; *see also 1990 Price Cap Order* ¶166 ("Exogenous costs are in general those costs that are *triggered by* administrative … action beyond the control of the carriers.") (emphasis added).

AT&T contends that the switch to accrual accounting was not beyond Verizon's control because, under the terms of the *SFAS-106 Order*, Verizon did not have to switch to accrual accounting until January 1, 1993, and its decision to do so before that deadline "was therefore entirely its choice and entirely within its control." Br. 35, *see id*. 37 (adoption before the deadline "was purely a matter of [Verizon's] choice and thus within the carriers' 'control'"). That claim fails because it relies on a mistaken understanding of the control test.

The Commission established price caps in order to give carriers the incentive to lower the costs within their control, but at the same time it recognized that some matters are not within their control. In particular, the Commission found that an administratively mandated cost change, unlike a general operating cost, is precisely the sort of matter that a carrier cannot control – and that is exactly why the Commission found that accounting changes "*will be considered* exogenous," *1990 Price Cap Order* ¶168 (emphasis added). Under the price cap regime, "control" does not turn on whether a carrier has some degree of choice about when to implement a change in accounting practices; rather, costs imposed by a regulator are considered categorically beyond a carrier's control. Such a cost is no less exogenous because the carrier can choose to incur that cost prior to a deadline rather than at a deadline: the control test asks not *when* a cost change takes place, but *why* it takes place, and if it takes place as a matter of a regulatory directive, it is not within the carrier's control.[7] *See Southwestern Bell*, 28 F.3d at 1169-1170. AT&T seeks to impose the broadest possible definition of "control," but the Commission reasonably declined to read that term so broadly. That interpretation of the Commission's own orders and rules is consistent with their terms and thus within the agency's interpretive authority. *Lyng v. Payne*, 476 U.S. at 939.

Southwestern Bell supports – and perhaps even requires – the agency's understanding of the control test. The Court found that changes in GAAP "become mandatory … after the Commission f[inds] them … consistent with the agency's regulatory objectives." 28 F.3d at 168. As long as the carrier must make the change, a choice as to timing does not render the change itself within the carrier's control. Indeed, the Court expressly rejected the view that a carrier's "control over the level *and timing* of OPEBs expenses" rendered those expenses within the carrier's control for purposes of determining exogenous treatment. *Id.* at 169 (emphasis added). Contrary to AT&T's claim (Br. 37-38), the Court's statement about timing can properly be read to apply to the timing of accounting changes as well as the expenses themselves, given the categorical nature of the control test. After FASB and the Commission have adopted an

[7] For that reason, AT&T is incorrect when it argues, Br. 34-35, that it is not consistent with the price cap regime to deem a mandatory accounting change beyond a carrier's control where the carrier may determine the timing of its adoption of the change. Cost changes required by a regulator are not the types of costs that the price cap regime is concerned with providing an incentive for carriers to restrain.

accounting change, implementation of that change is out of a carrier's control even if the Commission allows the carrier some degree of choice as to the precise timing. As the Commission put it, "[w]here … a governmental entity requires action 'on or before' a particular date, the act of complying 'before' the last permissible day is no less mandatory than the act of complying 'on' the expiration of the deadline." *2005 OPEBs Order* ¶28 (JA). The Commission was correct to find that "Verizon's implementation of SFAS-106 was not a 'voluntary' act because it elected to put the mandated accounting change into effect before January 1, 1993." *Ibid*.

B. The Commission Reasonably Found That SFAS-106 Was "Effective" Within the Meaning Of The Control Test When Verizon Implemented The New Practice.

The Commission ruled in the *1990 Price Cap Order* that "no GAAP change can be given exogenous treatment until the Financial Accounting Standards Board has actually approved the change and it has become effective. The price cap mechanism is intended to reflect changes in costs that have occurred, not anticipated cost changes." *1990 Price Cap Order* ¶168. FASB stated that SFAS-106 "shall be effective for fiscal years beginning after December 15, 1992." SFAS-106 ¶108 (JA). AT&T contends that the *2005 OPEBs Order* violates the *1990 Price Cap Order* because, given FASB's effective date, SFAS-106 cannot be a lawful basis for an exogenous increase for costs incurred before that date. AT&T's claim is that "[w]hen the promulgator of a rule specifies the effective date for the rule, that date is when the rule 'becomes effective.'" Br. 40.

AT&T's argument is predicated on the theory that "effective" for purposes of the *1990 Rate Cap Order* means the time when FASB makes a rule effective. But that term is subject to a number of plausible interpretations, depending on the context. The Commission read "effective" as used in its price cap program to mean that the effective date of a GAAP change is when the Commission itself permits or requires the implementation of the change. The Commission found that "Verizon implemented SFAS-106 after the Commission's staff … directed carriers to put SFAS-106 in effect 'on or before January 1, 1993 as a mandatory practice for purposes of the USOA.' Thus, at the time Verizon implemented SFAS-106, the carrier had been authorized to make that GAAP change effective for purposes of regulatory accounting 'before January 1, 1993' – a period of time that clearly encompasses 1991 and 1992." *2005 OPEBs Order* ¶25 (JA). That agency interpretation of its own prior order was reasonable and entitled to deference.

At the outset, the Commission's interpretation is compatible with the plain meaning of the word: an accounting change unquestionably becomes "effective" for a common carrier when the agency that directly regulates the carrier authorizes the change to be placed in effect for purposes of the carrier's regulatory accounts. That is so without regard to whether FASB, which does not regulate the regulatory accounts of common carriers, regards the standard as being in effect for its own purposes.[8]

Moreover, in the *1990 Price Cap Order*, the Commission drew a distinction between the time when FASB has "actually approved" a change in accounting practices and when that change "become[s] effective" for purposes of exogenous treatment. *1990 Price Cap Order* ¶168. In discussing when an accounting change could lead to exogenous cost treatment, the Commission cited an earlier tariff decision involving AT&T, which at the time was subject to its own separate

[8] In any event, FASB itself recognized the wisdom of immediate accrual accounting for OPEBs and expressly stated that "Earlier application [of SFAS-106] is encouraged." SFAS-106 ¶108 (JA). FASB established an effective date later than the adoption date out of concern that companies would not have access to the data needed to change to accrual accounting. *Id.* ¶¶388-389 (JA -).

price cap, with similar exogenous treatment rules. *Id*. at 6844 n.178. In that order, the Commission had rejected AT&T's attempt to obtain exogenous treatment of costs related to the change to accrual accounting for OPEBs. *American Telephone and Telegraph Co.*, 5 FCC Rcd 3680 (CCB 1990). AT&T had implemented its change to accrual accounting in anticipation of FASB's approving the rule, but before the accounting board had actually done so and before the Commission had authorized the practice. *Id*. at 3680 ¶4. The Commission rejected exogenous cost treatment on the ground that "exogenous costs can be *either* cost changes resulting from a change in [the FCC's] accounting rules *or in any Commission-approved change in GAAP*." *Id*. at 3680 ¶4 (emphasis added). For that reason, the *1990 Price Cap Order* described the effectiveness test as one "intended to reflect changes in costs that have occurred, not anticipated cost changes." *1990 Price Cap Order* ¶168. The "effective" test that the Commission implemented in reliance on the *AT&T* decision thus may properly include changes in accounting practices that have been authorized by the Commission even if they have not yet been made "effective" by FASB for more general accounting purposes.

AT&T claims that the result of giving carriers leeway as to when to adopt the switch to accrual accounting "leads to wholly arbitrary and inequitable outcomes" in which carriers can charge different rates based on when they adopted the new accounting practice. Br. 40-41. But there is no guarantee that all carriers' rates will be the same, and differences between them do not render the rates irrational or arbitrary. With respect to the accounting changes at issue here, all carriers were free to make the change at any time "on or before January 1, 1993." *SFAS-106 Order*, 6 FCC Rcd 7560. As discussed above, FASB had recognized that switching accounting methodologies might take some time due to the data required; the Commission presumably recognized the same thing when it gave carriers leeway over the implementation schedule.

Verizon apparently was able to implement accrual accounting sooner than the other carriers. But in the circumstances, there is nothing arbitrary or unfair about that outcome.

CONCLUSION

For the foregoing reasons, the petition for review should be denied.

Respectfully submitted,

THOMAS O. BARNETT
ACTING ASSISTANT ATTORNEY GENERAL

ROBERT B. NICHOLSON
ROBERT J. WIGGERS
ATTORNEYS

UNITED STATES DEPARTMENT OF JUSTICE
WASHINGTON, D.C. 20530

SAMUEL L. FEDER
ACTING GENERAL COUNSEL

RICHARD K. WELCH
ASSOCIATE GENERAL COUNSEL

JOHN E. INGLE
DEPUTY ASSOCIATE GENERAL COUNSEL

JOEL MARCUS
COUNSEL

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554
(202) 418-1740 (TELEPHONE)
(202) 418-2819 (FAX)

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IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

AT&T CORPORATION, PETITIONER, V. FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA, RESPONDENTS.	))))))))))))	NO. 05-1171

CERTIFICATE OF COMPLIANCE

Pursuant to the requirements of Fed. R. App. P. 32(a)(7), I hereby certify that the accompanying "Brief for Respondents" in the captioned case contains 13099 words.

JOEL MARCUS
COUNSEL
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554
(202) 418-1740 (TELEPHONE)
(202) 418-2819 (FAX)

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