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Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
Accounting for Judgments and Other Costs Associated with Litigation	)	CC Docket No. 93-240

REPORT AND ORDER

Adopted: March 11, 1997 Released: March 13, 1997

By the Commission:

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APPENDIX - Amendment of Part 32 of the Commission's Rules

I. INTRODUCTION

1. In this proceeding, we consider the Commission's accounting rules and ratemaking policies that should apply to litigation costs incurred by carriers subject to the Commission's Part 32 rules. The Commission had previously adopted rules and policies to govern the Commission's accounting treatment of litigation costs arising from lawsuits alleging the violation of antitrust and other federal laws. That decision was reversed and remanded by the United States Court of Appeals for the District of Columbia Circuit on the grounds that the Commission had neither adequately justified the application of its rules and policies to costs arising in lawsuits other than antitrust litigation nor sufficiently analyzed the effects of its rules and policies on carriers' litigative behavior. The court also found that the Commission had failed to explain why its change in the treatment of litigation costs did not constitute retroactive ratemaking. Based upon the record in this proceeding and changes to the Commission's ratemaking policies occurring since the Commission initially considered these accounting issues, we conclude that there should be special rules to govern the accounting treatment of federal antitrust judgments and settlements, in excess of the avoided costs of litigation, but not for litigation expenses. We further conclude that these special rules should not apply to costs arising in other kinds of litigation.

II. BACKGROUND

2. A fundamental requirement of Title II of the Communications Act of 1934, as amended, is that "all charges . . . for and in connection with [interstate] communication service, shall be just and reasonable." This provision safeguards consumers against rates that are unreasonably high and guarantees carriers that they will not be required to charge rates that are so low as to be confiscatory. Carriers under the Commission's jurisdiction must be allowed to recover the reasonable costs of providing service to ratepayers, including reasonable and prudent expenses and

a fair return on investment. This fundamental requirement is unchanged by the Telecommunications Act of 1996.

A. Ratemaking

3. The method for achieving just and reasonable rates has evolved over the years. Under traditional rate-of-return regulation still applied to most of the smaller incumbent local exchange carriers (ILECs), carriers set rates to recover their revenue requirements, which consist of allowable expenses and taxes plus a reasonable return on capital investment devoted to or "used and useful" in providing the utility service. In 1989 for AT&T and 1990 for the largest ILECs, the Commission adopted a different approach, commonly called incentive or "price cap" regulation, to give carriers pricing flexibility within limits designed to protect customers from unreasonably high rates and discriminatory pricing practices. The Commission's intent with price cap regulation is to create efficiency incentives like those found in competitive markets until actual competition makes price cap regulation unnecessary.

4. Limits are placed on the rates ILECs subject to price cap regulation may charge for regulated services. A carrier's services are grouped together in "baskets" on the basis of common characteristics, and the weighted prices in each group are adjusted annually pursuant to a formula applied to the benchmark price cap index. Although the Commission's goal is "pure" price cap regulation, the Commission has retained features of rate-of-return regulation for incumbent local exchange carriers by adding a backstop to the ILECs' productivity predictions. This backstop leads to rate adjustments whenever it appears that rates may fall outside the zone of reasonableness for tariff review purposes. ILECs for which interstate earnings in a calendar year exceed a specified return must share with ratepayers part or all of the earnings above that benchmark; those with earnings below a specified return may raise their price cap indices at the next annual tariff filing (the "low-end adjustment"). Price cap regulation is mandatory for the seven regional Bell operating companies and GTE. It is optional for other ILECs, although several have chosen it.

5. The Commission has adjusted the ILEC price cap plan on several occasions in response to court decisions and to changes in technology, regulation, and the market. In its first comprehensive review of price cap performance for ILECs, the Commission specified three

productivity factors from which price cap carriers could choose. Carriers selecting the highest factor and, therefore, increasing their price cap indices the least, will no longer have sharing obligations and will not be permitted to make low-end adjustments. Carriers selecting the smaller productivity factors will continue to be subject to sharing. The Commission currently is reviewing the way it sets the productivity factor used in the price cap formula, the need to retain sharing in a plan with multiple productivity factors, and the efficacy of possible alternatives to sharing. The Commission has also proposed a framework that could adapt ILEC price cap regulation to the emergence of competition for local exchange and exchange access services and eventually eliminate price cap regulation for interstate access services subject to substantial competition. Under the Telecommunications Act of 1996, streamlined tariff filing process will become effective in February 1997, but the price cap structure remains unchanged.

B. Accounting Requirements

6. Accurate identification of costs is central to the Commission's ability to carry out its responsibilities. The cost information that provides the basic data from which a carrier's rates are computed and evaluated under the just and reasonable standard is retained in accounts prescribed by the Commission's rules. The Commission is authorized under Section 220(a)(1) of the Communications Act of 1934, as amended, to prescribe the forms of accounts to be kept by carriers subject to its jurisdiction and by subsection (a)(2) to prescribe by rule a uniform system of accounts for use by all telephone companies, "which shall ensure a proper allocation of all costs to and among telecommunications services, facilities, and products . . . which are developed, manufactured, or offered by such common carrier." The accounting classification does not conclusively determine whether a particular expenditure will be allowed or disallowed for ratemaking purposes, but it does create presumptions that affect the ratemaking treatment of the expense for ILECs subject to rate-of-return regulation or sharing obligations under price cap regulation. Accounting for an expense "above the line" creates the rebuttable presumption that the expense will be allowed in the revenue requirement and will become the responsibility of ratepayers. Conversely, accounting below the line creates the rebuttable presumption that the expense will be disallowed in a rate case, making it the responsibility of the shareholders.

7. The larger ILECs, the Class A telephone companies, periodically report to the Commission the information collected in the USOA, and that information is placed in the Commission's Automated Reporting Management Information System (ARMIS) used to monitor carrier investment and expenses and administer the Commission's accounting, separations, joint costs, and access rules. Similar data were collected from AT&T until its reclassification as a nondominant carrier. Furthermore, when an ILEC moves to price cap regulation, its interstate access rates established under rate-of-return regulation form the basis for the price cap filing, just as AT&T's interstate rates were the starting point for its conversion to price cap regulation. When a price cap ILEC offers a new service, it must meet the new services cost test to establish a cost record for the service before implementing price cap pricing.

8. Most of the smaller companies, many of which are classified as "average schedule companies," keep their accounts according to the Uniform System of Accounts but are exempt from cost allocation procedures and are not required to make individual cost showings to justify their rates. Unlike the larger "cost schedule" companies, average schedule companies are compensated for interstate common carrier services on the basis of formulas designed to simulate the disbursements that would be received by a cost schedule company that is representative of average schedule companies. The formulas are based on sampled data from average schedule companies and from completed cost studies of representative cost schedule companies. This process is administered by the National Exchange Carrier Association (NECA).

C. Litigation Costs

9. Historically, the Commission allowed carriers to record litigation expenses in above-the-line accounts and retained the option of disallowing such costs on an ad hoc basis in ratemaking proceedings. Litigation tended to arise from contract disputes, tort liability for accidents, or worker's compensation claims, which were viewed as matters arising out of the ordinary course of business. Penalties and fines paid on account of violations of statutes, however, were recorded below the line.

10. In the 1970's, government and private antitrust litigation involving AT&T and other carriers subject to the Commission's jurisdiction increased substantially. Anticipating the need to

determine whether the large sums AT&T spent defending these antitrust suits should be charged to ratepayers or shareholders, the Commission initiated a Notice of Inquiry in 1979 to develop a policy of general applicability so that it could avoid having to make this determination in each future rate proceeding. The Commission concluded that tariff and rate case review mechanisms provided suitable fora for identifying and disallowing such costs. Additionally, however, the Commission asked the Telecommunications Industry Advisory Group that was rewriting the Uniform Systems of Accounts for telephone companies whether more detailed accounts or reports for litigation expenses were needed.

11. The Commission revisited the question after the substantial treble damages antitrust judgment in the Litton Systems case became final against AT&T and its former subsidiaries, the regional Bell operating companies. The Commission ordered AT&T and the regional Bell operating companies to record the Litton Systems judgment below-the-line in the nonoperating account used for penalties and fines for violating statutes, and it further ordered that they credit the operating accounts in which they had carried their defense costs and reclassify these costs to the same nonoperating account in which the judgment was to be recorded. Although this was only an accounting change, this change presumptively removed these costs from the ratemaking process. After the Commission denied reconsideration, the carriers sought judicial review of accounting treatment and resulting presumption for their litigation expenses. They did not challenge the treatment of the antitrust judgment or the interest thereon.

12. The Commission also conducted a rulemaking proceeding to clarify the accounting treatment of litigation costs incurred in both antitrust lawsuits and other lawsuits in which violation of any federal law was alleged. It concluded that payments incurred as a result of adverse antitrust judgments or post-judgment settlements should be recorded below the line in a nonoperating account, but allowed ratemaking recognition of the saved litigation expenses of the suit. The ongoing costs of defending the litigation would continue to be recorded in an operating account as accrued but would be transferred to a nonoperating account when a judgment adverse to the carrier became final or if a settlement were entered after an adverse judgment. This accounting treatment was extended to litigation costs arising from alleged violations of any federal law. As with the

Litton Accounting Order, this treatment presumptively removed from the ratemaking process the litigation costs other than certain pre-judgment settlement costs arising from a carrier's violation of antitrust and other federal laws, and shifted to the carriers the burden of showing the reasonableness of including such costs in their revenue requirements. This, too, was challenged.

13. The Court of Appeals for the District of Columbia Circuit vacated both Commission orders on the same day and remanded each case for further proceedings. In Litton Accounting Appeal, the court was not persuaded that the illegality of the underlying carrier conduct was a sufficient reason, by itself, for exclusion of the litigation defense expenses from ratemaking and admonished the Commission to scrutinize the reasonableness of the expenses with "a wider and more discriminating focus." The court also found that the Commission's policy was not sufficiently explained.

14. In Litigation Costs Decision, the court remanded the Commission's Litigation Costs Proceeding because: (1) the Commission did not adequately justify application of the rules to violations of federal law other than antitrust law; and (2) the Commission did not sufficiently consider the probable effects of its rule on the companies' incentives to either settle or litigate lawsuits. The court also stated that the Commission had failed to explain why its reclassification of litigation costs was not retroactive ratemaking. Although the court vacated the Commission's orders, it specifically acknowledged the Commission's "special responsibility . . . regarding the competitive behavior of the common carriers subject to its oversight." In discussing the accounting treatment for antitrust judgments, the court stated that the Commission may disallow any expense incurred as a result of carrier conduct that cannot reasonably be expected to benefit ratepayers and that the Commission acted reasonably in aligning the presumption against recovery with the majority of antitrust cases in which consumers do not benefit from the conduct occasioning liability. The court found no fault with the Commission's treatment of either adverse antitrust judgments or pre-judgment settlements in antitrust cases, although it faulted the Commission for failing to consider the possible perverse incentives arising from its asymmetric treatment of post-judgment settlements, which ultimately could also increase the amount recoverable from ratepayers. The court agreed that the same rationale that the Commission used in determining that an ILEC could not recover an

antitrust judgment also applies with respect to litigation expenses because the reasonableness of the underlying conduct, not the defense of the conduct, determines whether the expense is reasonable.

III. CURRENT PROPOSAL

15. In the current docket, the Commission has proposed accounting rules that would: require carriers to account for adverse antitrust judgments and post-judgment antitrust settlements below the line in Account 7370, a nonoperating account for special charges; defer other antitrust litigation expenses during the pendency of antitrust litigation; and account for the expenses below the line in the event of an adverse judgment or a post-judgment settlement. If a pre-judgment settlement occurred, the litigation expenses actually incurred and any avoided costs of litigation that are a direct result of the settlement of the suit would be booked below the line in a nonoperating account but recovered in the ratemaking process. The Commission has also proposed that any rules adopted will be applicable to state as well as federal antitrust lawsuits and also to non-antitrust lawsuits involving violation of federal statutes in which the actions giving rise to the litigation did not benefit ratepayers. Pending action on these proposals, carriers have been recording antitrust judgments and settlements in Account 1439, Deferred charges, with the expectation that these charges would be treated in accordance with any rules ultimately adopted in this docket.

IV. COMMENTS

16. Comments generally opposing the proposal were received from the United States Telephone Association (USTA), the Ameritech Operating Companies (Ameritech), the Bell Atlantic Telephone Companies (Bell Atlantic), BellSouth Telecommunications, Inc. (BellSouth), the New England Telephone and Telegraph Company and New York Telephone Company (NYNEX), Pacific Bell and Nevada Bell (the Pacific Companies), Southwestern Bell Telephone Company (SWBT), U S West Communications, Inc. (U S West), and COMSAT Corporation (COMSAT). MCI Telecommunications Corporation (MCI) and Scott J. Rafferty (Rafferty) filed comments generally supporting the proposal. Reply comments were received from MCI, Rafferty, USTA, BellSouth, NYNEX, the Pacific Companies, SWBT, COMSAT, and GTE Service Corporation and its affiliated domestic telephone operating companies (GTE).

V. DISCUSSION

A. Need for Rule Change

17. The question in this proceeding is a narrow one: whether the Commission should by rule revise the accounting treatment for costs associated with litigation, particularly antitrust litigation. As commenters have emphasized, however, the consequences are broader. Parts of the proposal in the NPRM, if adopted as proposed, would change presumptions of recovery of the costs in ratemaking proceedings, impose tracking and recordkeeping burdens on the subject carriers, and affect incentives to litigate. In addressing the issues raised by our proposal, we have carefully considered these consequences. We have also considered the proposal in the context of changes in our regulation of the ratemaking process relevant to the proposed accounting changes.

18. We have concluded that our rules should require that adverse antitrust judgments be accounted for below-the-line in Account 7370. This would include any associated interest and awards of attorneys fees to adversaries. Fines and penalties have always been accounted for below-the-line, and this practice will continue. We have also concluded that settlement costs paid by carriers to resolve antitrust litigation should be accounted for below-the-line in Account 7370, but we have modified our proposal to allow carriers to recover in ratemaking the saved litigation expenses of both pre- and post-judgment settlements entered before any adjudication of anticompetitive misconduct becomes final. We have also concluded that we should change how we treated the costs of defending antitrust litigation. In the previous rulemaking, we allowed litigation expenses associated with a adverse judgment or a post-judgment settlement to be recorded above-the-line but made them subject to "recapture." This recapture doctrine created a presumption that these expenses would be excluded from a carrier's revenue requirements. In the present rulemaking, we alter the presumption to provide that these costs may continue to be recorded above the line in operating accounts. Finally, we have concluded that the record before us provides insufficient basis for changing the current accounting treatment of alleged or adjudicated violations of state or federal laws other than federal antitrust laws. This means that only costs related to judgments or settlements in lawsuits stemming from violations of federal antitrust laws will be recorded below-the-line. With regard to settlements of such lawsuits, there will be a presumption that carriers can recover the portion of the settlement that represents the avoidable costs of litigation,

provided that the carrier makes the required showing, as defined in paragraphs 45-46, infra.

19. USTA and BellSouth have argued that antitrust litigation has not occurred often enough within recent years to constitute a problem within the industry. We disagree with the contention that a recent decline in antitrust litigation establishes that such litigation could not occur again. We do not find this to be a persuasive reason for failing to be prepared for determining the proper accounting treatment for antitrust litigation expenses. Our past experience in trying to make such determinations on an ad hoc basis persuades us that the certainty provided by a clear rule is preferable and that the time to define that rule is when carriers are not embroiled in major litigation. Because adequate rules were not in place during the 1970's and 1980's, ratepayers bore the costs of settlements in antitrust cases. Ratepayers and taxpayers alike bore the costs of litigating how litigation costs should be booked in the Litton Accounting Proceeding.

20. We are also unpersuaded by the argument that we should not determine the accounting treatment for the smaller ILECs, because the smaller ILECs, those not required to use price caps, are not likely to violate the antitrust laws. When the Commission distinguished dominant from nondominant carriers in its competitive carrier rulemaking, it determined whether a firm possessed market power, or the power to control prices, by looking at market features, including "the number and size distribution of competing firms, the nature of barriers to entry, . . . the availability of reasonably substitutable services," and whether the firm controlled "bottleneck facilities." All ILECs were considered to be dominant because they possessed these characteristics within their service areas, even if not on a national basis, and the Commission has not changed this categorization for the ILECs. In the Virtual Collocation Rates Phase I Report and Order, the Commission disagreed with the assertion that an ILEC has no economic incentive to engage in anticompetitive behavior. Noting that the Common Carrier Bureau had concluded in its tariff suspension order that the Tier 1 ILECs were strategically assigning high overhead loadings to deter competitive entry into the interstate access service market, and finding that the ILECs had not justified their overhead loading levels, the Commission rejected the ILEC virtual collocation rates as unjust and unreasonable and ordered a refund. "While predation may be infrequent, under certain market conditions it may be a profitable strategy." The Commission further observed that

anticompetitive pricing can also occur when a monopoly provider assigns high overheads to bottleneck facilities upon which competitors rely, while assigning low overheads to the services against which competitors seek to compete. In Intelligent Network, the Commission's concern about ILEC resistance to open network policies led to a proposal that Tier 1 ILECs be required to open their networks to potential competitors to some degree. The Commission can make its best efforts to minimize anticompetitive behavior but cannot guarantee that carriers who could potentially restrict entry or affect prices will not commit violations of the antitrust laws in the future. It is in the public interest to have accounting rules in place if judgments do occur. The rules we are enacting in this Order do not impose burdens on conforming carriers.

21. Although this rulemaking proceeding addresses the narrow issue of the appropriate accounting treatment for antitrust litigation costs, it must be viewed in the broader context of our responsibility under Title II, Section 201(b) of the Communications Act to ensure that all rates charged by carriers are lawful, i.e., that they are "just and reasonable." This means that a carrier's operating expenses recovered through tariffed rates must be "legitimate" costs of providing service to ratepayers. Carriers argue that the treatment of litigation costs may not directly affect rates for price cap carriers, but even for price cap carriers accurate cost accounting provides the basic data for determining jurisdictional separations and for enforcing the Commission's competitive policies. Additionally, the treatment of litigation costs does affect the calculation of any sharing obligations a carrier may have under price caps. We have sought a result here that will minimize the burden to carriers from this accounting change and, at the same time, avoid burdening ratepayers -- and possibly other telecommunications carriers -- from bearing the costs of anticompetitive misconduct.

B. Adverse Antitrust Judgments

22. In the NPRM and earlier in the Litigation Costs Proceeding, the Commission stated that anticompetitive behavior that leads to an adverse antitrust judgment "rarely, if ever produces any benefit for ratepayers," although the corporate strategy leading to the adverse judgment could benefit shareholders if management successfully avoids liability. MCI agrees, and NYNEX and the Pacific Companies do not dispute this view. U S West argues that this proceeding is unnecessary because antitrust judgments have always been subject to Commission scrutiny. Other commenters

opposing the Commission's proposal, however, argue that antitrust judgments are operating expenses
incurred in the normal course of business, or result from changing standards or the lack of a line
between aggressive competition and anticompetitive conduct.

23. We are not persuaded by opponents' arguments that adverse judgments should be
recorded in operating accounts. We do not share opponents' views that anticompetitive behavior is
the business of a carrier or that the cost of antitrust violations is a normal cost of doing business.
The Commission increasingly relies on competition to control prices and stimulate new entrants and
services, and has expended considerable effort to prevent anticompetitive conduct. An antitrust
judgment results only after a court concludes, on the basis of the evidence before it, that the conduct
at issue has violated the law. The antitrust laws define impermissible conduct, and carriers, like
other businesses, push the line between aggressive competition and anticompetitive conduct at their
own risk. Although, as BellSouth and SWBT argue, different federal antitrust courts may draw
different conclusions from seemingly similar circumstances, the court is the appropriate forum for
testing the evidence and arguing its weight, and the system provides for appeals of an unfavorable
judgment. While it may also be true that the understanding of what constitutes anticompetitive
conduct evolves as different types of conduct are scrutinized under the antitrust lens, we find that
this is not a reason for this Commission to make light of an adjudicated antitrust violation.
Competition may be "a ruthless process," as COMSAT advises, but the antitrust laws place limits,
as COMSAT acknowledges. We consider it inappropriate to use our accounting prescription and the
accompanying ratemaking presumptions to lessen the compliance incentives created by the antitrust
laws, which could occur if we placed some or all of the monetary risk of an adjudicated violation
on ratepayers rather than shareholders. U S West's and SWBT's argument that the expense may be
disallowed on a case-by-case basis does not take into account the burden on ratepayers or the
Commission when seeking disallowance in a ratemaking proceeding after a carrier has been
adjudicated to be a wrongdoer. In our view, where anticompetitive conduct occurs, the burden is
more appropriately placed on the carrier, which has the information about its conduct. This is fully
consistent with the Commission's requirement in Litton Accounting Proceeding that the adverse
judgment be accounted for below-the-line.

24. SWBT argues that antitrust liability may be imposed even when the conduct at issue consists of the carrier adhering to its tariffs, which it is required by law to do, and even when conduct such as under-allocating the costs of some services is required of carriers by the Commission or state regulators to achieve policy goals. This argument is akin to the implied immunity defense sometimes raised in antitrust litigation involving a regulated entity. If a carrier is caught between incompatible regulatory requirements and antitrust enforcement, or if its conduct resulted from good faith adherence to regulatory requirements, it should make these points as a defense in the antitrust litigation where they can be weighed along with the challenged conduct. Tariffs filed with the Commission are initiated by the carriers, however. The pricing decisions contained in the tariffs should reflect regulatory policy, but also the specific decisions generally reflect the carrier's business judgment rather than regulatory coercion, and often are not specifically approved by the Commission. When the streamlined tariff filing process becomes effective for ILECs in February 1997, advance review will be even less likely. Thus, even though a carrier is required to adhere to its tariffs in order to avoid unlawful discrimination for like communications services, the carrier may comply with this requirement of the Communications Act and still commit violations of the antitrust laws. For these reasons, we are not persuaded that we should abandon our proposed requirement that antitrust judgments be recorded below-the-line in a nonoperating account.

25. COMSAT argues that antitrust lawsuits are complex and often have no clear winner or loser as, for example, when a carrier is sued for a large amount but judgment is entered against it for a lesser amount. Our concern, however, is with any judgment resulting from an antitrust violation. The possibility that the outcome could have been worse does not show how the underlying conduct could be expected to benefit ratepayers and is not a sufficient basis for finding that ratepayers should be responsible for paying any judgment costs through their rates. The Court of Appeals in Litigation Costs Decision agreed "that it is a legitimate aim of rate regulation to protect ratepayers from having to pay charges unnecessarily incurred, including those incurred as a result of the carrier's illegal activity -- of whatever sort." The court explained:

> The theory of the antitrust laws supports the FCC's observation that activities that give rise to antitrust liability do not generally benefit

ratepayers. See R. Bork, The Antitrust Paradox 7 (1978) ("the only legitimate goal of antitrust is the maximization of consumer welfare"). . . . The Commission acted quite reasonably . . . in aligning the presumption (against recovery) with the majority of antitrust cases, in which consumers do not benefit from the conduct occasioning liability.

26. COMSAT, USTA, and SWBT argue that reliance on the Litigation Costs Decisionpanel's analysis is misplaced because, under Litton Accounting Appeal, the success or failure of the litigation cannot be the sole determinant of the presumptive allowance or disallowance of litigation expenses, including the expenses of an adverse judgment. USTA adds that the result, not the language of Litigation Costs Decision, is controlling because the Commission's Litigation Costs Proceeding was vacated in its entirety. We disagree. The petitioners in Litton did not challenge the Commission's decision to disallow the judgment. The issue, therefore, as to whether it is reasonable for the Commission to presumptively disallow antitrust judgments was not before the court in the Litton Accounting Appeal. That issue, however, was before the court in the Litigation Costs Decision and the court in that case expressly concluded that it was reasonable for the Commission to presumptively disallow antitrust judgments. The court explains why its remand was limited to two issues, which specifically did not include the Commission's alignment of the presumption against recovery with the majority of antitrust cases. We reject, moreover, USTA's suggestion that we interpret the Litigation Costs Decision in a manner that is contrary to the language and rationale of that decision.

27. We also read Litton Accounting Appeal more narrowly than COMSAT, USTA, and SWBT do. Litton Accounting Appeal dealt only with an indirect cost of the carrier's conduct, i.e., the cost of defending against allegations of anticompetitive misconduct. The court questioned whether the subsequent finding that the underlying conduct was illegal compels or warrants rejection of the defense expense in the ratemaking process, particularly when the carrier had properly tracked its expenditures in above-the-line accounts with the expectation that these would be treated as operating costs in ratemaking. The Commission's accounting treatment of the adverse judgment, the direct cost of the misconduct, was not before it and, thus, not addressed by, the court. In

reviewing the Commission's treatment of the carrier's defense costs, the court observed that, in
another context, the costs of defending a carrier's business activities have been considered ordinary
and necessary costs of the business. The court further observed that Litton defense costs had
previously been treated as properly incurred, and the Commission had not scrutinized the
reasonableness of those costs before concluding that they were not legitimate operating expenses.
We see no inconsistency between the admonition in Litton Accounting Appeal that we consider the
reasonableness of the costs of defending against an allegation of antitrust misconduct before
presumptively excluding those costs from the ratemaking process and the presumption in Litigation
Costs Decision that the direct costs of adverse antitrust judgments do not benefit ratepayers. An
adverse antitrust judgment is the outcome of court scrutiny of the carrier's conduct and the finding
that misconduct caused damages of a specified monetary value. When the judgment as to damages
becomes final, the judgment costs are entered in the appropriate account. There is no problem of
later changing the accounting treatment, which concerned the court in Litton Accounting Appeal.
Also, any burden on the ILECs is more than offset by the benefits of protecting ratepayers against
unnecessary costs.

28. Bell Atlantic fears that rate-of-return carriers will be burdened by the need for a separate
proceeding each time an antitrust action against a carrier is resolved by judgment. According to
USTA and BellSouth, however, adverse judgments are rare, and the record contains no information
to the contrary. We do not see an unreasonable burden on carriers if they seek to persuade the
Commission that the underlying adjudicated misconduct was undertaken in the interest of
ratepayers.

29. In conclusion, once a court has made an adverse determination, and that determination
has become final, we will presume that the underlying conduct did not benefit ratepayers unless the
carrier can make a showing to the contrary. The judgment costs must be accounted for below-the-
line in Account 7370 as a nonoperating expense and, absent a showing of ratepayer benefit,
presumptively removed from the ratemaking process. Carriers should make any showings in a
request for special relief rather than burden the ratemaking process itself with the determination.

C. Settlements

30. The Commission, in the Litigation Costs Order, required that all antitrust settlements be recorded below-the-line. On reconsideration, the Commission created a presumption that a portion of pre-judgment settlements could be recoverable from ratepayers. That portion was defined as "the amount corresponding to the additional litigation expenses, expressed in present value terms, which the carrier reasonably estimates it would have paid if it had not settled and which the carrier would have allocated to the interstate jurisdiction under Part 36 of our rules, 47 C.F.R. Part 36." Although the Litigation Costs Recon. Order and the NPRM both use the term "nuisance value" in connection with this presumption, they are referring to the definition quoted above. Because the phrase "avoided costs of litigation" describes the portion of a settlement that is potentially recoverable in the ratemaking process under the definition in the Litigation Costs Recon. Order, we will use that term, rather than "nuisance value," in this Order.

31. In remanding Litigation Costs Order to the Commission, the court agreed with the Commission's reasoning that, once the agency requires a judgment to be recorded below-the-line, "failing to accord similar treatment to a settlement of the same action would create a strong incentive for a carrier to settle such a suit even if the settlement is for an amount greater than the expected liability." The court accepted the concept of a nuisance value exception, also known as the avoided costs of litigation exception to the presumption against recovery of settlement costs but faulted the Commission for failing to address the incentives it created by treating the value of the avoided costs of litigation of pre- and post-judgment settlements disparately, because "the economics of the two situations are identical."

32. Relying on the court's analysis, the Commission again proposed that carriers record antitrust settlements below-the-line, in Account 7370 because "this approach is most consistent with the underlying principle that expenses not incurred for the benefit of ratepayers should not be routinely passed on to ratepayers." It also asked for comment on readopting an exemption from this treatment for the litigation expenses saved by pre-judgment settlements, but not for such expenses saved by post-judgment settlements.

33. The treatment of settlements poses a more complex problem than does the treatment of adverse judgments, for, as commenters remind the Commission, liability is neither established nor

admitted. MCI argues that all settlement costs should be accounted for below-the-line and presumed not recoverable from ratepayers unless the carrier can show that the settlement was in the interests of ratepayers. If the avoided litigation costs are allowed in the revenue requirement, MCI advocates that a low dollar limit on that value should be set. Other commenters assert that settlement is a business decision and should be evaluated only on the basis of the reasonableness of that decision in light of all the factors affecting the decision. They oppose any rule that requires accounting for settlement costs below-the-line, particularly where this treatment would result in disallowing these costs from a carrier's revenue requirements. In the alternative, they argue that the Commission, in ratemaking, should at least allow carriers to recognize the litigation costs that are avoided because of a settlement, regardless of whether the settlement occurs before or after any adverse judgment.

34. Our ultimate objective in resolving the accounting treatment of antitrust settlements is to ensure that ratepayers obtain just and reasonable rates and ensure that expenses not incurred for the benefit of ratepayers are not recovered from them. In pursuing this objective, we are also mindful that rates are not just and reasonable if a carrier cannot recover legitimate and prudent expenses incurred in operating the business for the benefit of ratepayers, plus a fair return on its investment. We also seek a resolution that avoids burdening carriers and their ratepayers with unnecessary administrative costs and avoids creating regulatory incentives to litigate or settle on the part of carriers and their adversaries.

35. With these goals in mind, we conclude that the Commission's accounting rules should treat monetary settlements of antitrust litigation like adverse antitrust judgments. As the court acknowledged in Litigation Costs Decision, failing to do so could create an incentive to settle antitrust litigation even if the settlement exceeds the expected liability. We also agree with the court that:

> [F]ailing to require settlements to be recorded below-the-line would obviously compromise the integrity of the regulatory scheme: if the activity resulting in the lawsuit was for the benefit of the carrier, rather than for that of the ratepayers, there is no reason for requiring ratepayers to pay the cost of the settlement, even if it is in an amount

less than the carrier's expected liability.

36. Most commenters argue that a settlement cannot be used as an admission of misconduct, and they object to any implication that a carrier settles a lawsuit because a violation occurred. The Commission does not presume that the conduct at issue in a lawsuit is unlawful until a judgment to that effect becomes final. We do not intend to dismiss allegations of anticompetitive misconduct by accepting antitrust settlements, no matter how large, as business as usual. The Pacific Companies argue that settlement conserves judicial resources and reduces business uncertainty, and that settlement benefits ratepayers by permitting parties to resolve their differences at reduced costs and freeing business to spend resources on providing services. Such benefits may follow from settlements, but this does not eliminate our special concern that antitrust settlements should be shown to benefit ratepayers before ratepayers are required to pay for them. NYNEX argues that the Commission can always disallow settlement costs in ratemaking if there is evidence of improper incentives, such as agreeing "to a settlement that is judged excessive when compared to the probability of a violation being found and the expected litigation expenses and judgment." MCI questions whether this is likely in light of Litton Accounting Order in which an allowance and subsequent disallowance were overturned. NYNEX also argues that competitive marketplace forces provide a disincentive for bearing unnecessary costs. We note that the NYNEX test for an excessive settlement could require Commission evaluation of the underlying lawsuit, we therefore reject it as unduly subjective. The Pacific Companies argue that ratepayer benefit is found in the general policy favoring settlement. This policy benefits courts and litigants by reducing caseloads, but does not explain why ratepayers should bear the full burden of settlement. The majority of commenters strongly prefer that all settlement costs be treated as operating expenses. As a fallback, however, they support adoption of a presumption that at least the avoided litigation costs of a lawsuit is recoverable from ratepayers.

37. We recognize that litigation involves risks, uncertainties and expense. We also recognize that carriers consider factors other than fear of an adverse judgment in reaching a settlement, and that there may be benefits to ratepayers from avoiding litigation costs in some instances. Settlement payments beyond the avoidable costs of litigation, however, raise questions about whether such

payments would be reasonable or necessary if there were not a possibility that the carrier would be found to have engaged in anticompetitive conduct. In light of our duty to prevent ILECs from charging rates based upon "illegal, duplicative, or unnecessary" costs, we again conclude that carriers must justify recovery of payments to settle a lawsuit by showing the factors inducing the carrier to settle and demonstrating the benefit to the ratepayers.

38. SWBT objects to the Commission's proposal, arguing that allowing recovery of the avoided litigation costs of settlements entered before judgment creates an artificial incentive to settle early, before much is spent on discovery and pretrial motions for summary decision are resolved. One alleged harm is that a carrier will have less incentive to settle as the case proceeds toward trial, because fewer future costs will be available for inclusion in the calculation of avoided litigation costs. This argument fails to take into account the numerous factors SWBT and other commenters advise will affect settlement decisions, particularly as trial preparation continues and the parties gain insight into the strengths and weaknesses of each other's positions. Another alleged harm is that limiting ratemaking recognition to the avoided litigation costs will discourage carriers from aggressively litigating nuisance suits in order to deter future suits, thereby creating an artificial incentive for adversaries to bring suits of dubious merit. Absent the limitation to the avoidable litigation costs of settlements, SWBT argues, a carrier might litigate aggressively to deter meritless suits or excessive claims in the future, even though a case could be settled for less than the litigation costs, in order to keep future settlement claims reasonable. If limited to the avoidable costs of litigation, SWBT continues, a carrier would be inclined to pay up to the avoidable costs limit, even if that is excessive under the circumstances. In the Litigation Costs Decision, however, the court stated that "we do not accept the intervenors' claim that the rule providing for a pre-judgment settlement to be recorded above-the-line only to the extent of its 'nuisance value' (that is, in the amount of estimated litigation expenses avoided by reason of the settlement) provides an undue disincentive for carriers to settle lawsuits." An adversary who knows that the carrier's incentive is either to settle quickly for no more than the avoidable costs of the litigation or to litigate aggressively may be more inclined to settle, however. Our proposal would not hinder a carrier from either settling for less than the avoidable costs of litigation, where warranted, or to litigating

aggressively. As discussed later, the costs of the litigation will be borne by the ratepayers if not recovered from the adversary, and, if the suit lacks merit as SWBT contends, there should be no judgment adverse to the carrier. While SWBT might prefer that recognition of the costs of settlements be unlimited, we find its criticism of the proposal to limit recognition of the settlement costs of antitrust lawsuits to the avoidable costs of litigation to be unpersuasive.

39. The Commission previously limited only to pre-judgment settlements the presumption that avoidable costs of litigation should be allowed and, although the court had directed it to consider the incentive effects of any pre- and post-judgment distinction, the Commission again proposed to limit the presumption of recoverability for the avoidable costs of litigation to pre-judgment settlements. It reasoned that a post-judgment settlement occurs only after a court has made findings that a carrier engaged in illegal activity. Most commenters oppose this distinction. They argue that, while many of the same considerations that impel settlement at the trial level are relevant to settlement at the appeal level, the outcome can change as a result of an appeal, and the distinction creates an incentive for protracted post-judgment litigation.

40. On further analysis, we have decided to abandon the distinction between pre- and post-judgment settlements in cases where a finding of antitrust liability has not become final. As the court advised in Litigation Costs Decision, "the economics of the two situations are identical." Furthermore, we are presumptively allowing above-the-line accounting for all defense costs, including those incurred after an adverse judgment. Creating a presumption in favor of allowing recovery of the avoided costs of litigation of post-judgment settlements in ratemaking is consistent with this treatment of defense costs. As a result, recovery of the costs of defending litigation should not weigh heavily in the carrier's analysis of the pros and cons of settling a case and should not offer adversaries any special leverage against a carrier. Avoiding the impact of the accounting and ratemaking treatment of an adverse judgment is likely to have a stronger influence on a carrier's settlement decisions, because the cost of an adverse judgment will not be presumptively recoverable through rates. Refusal to create a presumption that ratemaking should treat the value of a settlement up to the avoidable costs of litigation as an allowable expense may detract somewhat from

the carrier's incentive to settle, but this will not be the only or even a primary consideration, according to some commenters. By refusing to permit ratemaking recognition of antitrust settlements, except for the portion that represents the avoidable costs of litigation, we are not burdening ratepayers with settlements and will not create an incentive to use post-judgment settlements as a way to avoid the consequences of an adverse final judgment. We find that this is a better balance of the ratepayers' and carriers' interests in just and reasonable rates than our NPRMproposal, because the fact of carrier misconduct has not been finally resolved. This result also responds to both the court's concern in Litton Accounting Appeal that carriers defend themselves and to the court's questions in Litigation Costs Decision about the reasonableness of incentives created by the Commission's previous pre- and post-judgment distinction.

41. Settlements entered into after an adjudication of liability for an antitrust violation has become final by the termination of all appeals cannot be recovered in the ratemaking process, even if litigation over damages continues. This applies even to the avoided costs of litigation. Once the fact of the violation has been conclusively established, ratepayers should not be asked to pay for the consequences, even in part and even if the carrier is able to negotiate a settlement on more favorable terms than the verdict. Absent a showing of ratepayer benefit from the adjudicated misconduct, the carrier should be responsible for its misconduct. We recognize that this accounting treatment might encourage post-judgment settlements before the appeal process becomes final, but this incentive is no different than the incentive to settle created by our treatment of final adverse judgments.

42. The Pacific Companies argue that the Commission should broaden the definition of the avoidable costs of litigation "to recognize the fact that a settlement avoids the hazards of litigation, conserves scarce employee resources (e.g. the time of both legal and non-legal employees to continue to litigate), and saved lost opportunity and other hidden costs." We disagree, for there would be no realistic limit to the amount of a settlement that would be recognizable in the ratemaking process with so broad and imprecise a definition. In Alascom, the only case for which the Commission scrutinized an antitrust settlement under its previous litigation cost rules, only the documented estimates of costs saved as a direct result of the settlement were presumptively recoverable. The Commission denied recovery of costs that would have been incurred without

regard to the litigation, such as the salaries of employees already on the payroll or employee opportunity costs, because no additional payment of money would have been required to support the litigation. The Commission also denied recovery under the ratepayer benefit test of costs incurred as a result of deferred investment, because business decisions regarding capital investment are ongoing for any carrier facing litigation, imposing these costs under the guise of settlement recovery would render the litigation costs policy meaningless, and the alleged saved costs were too speculative. The definition of the avoidable costs of litigation proposed by the Pacific Companies suffers from these same flaws. We continue to believe that the direct result test, which allows recovery of only the documented estimates of costs saved as a direct result of the settlement, is the appropriate test for the recovery of the avoidable costs of litigation, because it is tied to estimates that can be attributed directly to the costs of the litigation at issue and reasonably quantified. Furthermore, using a direct result test will discourage the recovery of excessive costs.

43. When the Commission previously allowed recovery for pre-judgment settlements, it stated that a pre-judgment settlement would be "presumptively recoverable from ratepayers" to the extent of "the additional litigation expenses ... which the carrier reasonably estimates it would have paid if it had not settled and which the carrier would have allocated to the interstate jurisdiction." This was the standard for the avoidable costs of litigation established upon reconsideration in that proceeding. The court confirmed that the Commission acted within its authority in allowing carriers to recover, for ratemaking purposes, the portion of the settlement of an antitrust lawsuit that represents its "nuisance value," otherwise known as the avoided costs of litigation. Pointing to the Alascom proceeding, U S West argues that the administrative burden required on the parts of the Commission and the carriers in identifying the avoided costs of litigation outweighs any benefit that ratepayers may receive from this treatment of settlement expenses. Thus, U S West argues, all settlement costs should be treated as normal operating expenses. We agree that the Commission does not accomplish much if antitrust litigation expenses are subject to a burdensome Commission review that imposes heavy costs on ratepayers, shareholders, the Commission, and taxpayers. But, we do not agree that the appropriate response is to allow settlement costs in any amount as operating expenses, for this could place all the burden of the settlement on ratepayers, whether or not they

benefit from settlement. This also could reduce a carrier's incentive to seek the most advantageous settlement terms, while encouraging potential adversaries to seek profit from a carrier's perceived deep pockets. Although USTA argues that market and customer pressures give carriers sufficient incentive to contain litigation costs, there is no guarantee that these pressures will prevent excessive settlements under all circumstances. These pressures and our action here are complementary.

44. Instead, to minimize the burdens on all concerned, we will presume that all settlements of lawsuits brought under federal antitrust laws are for the avoided costs of litigation to the extent that the carrier makes the required showing, as defined infra in paragraph 46 and 47, and, while recorded below the line, can be presumed recoverable in ratemaking. We recognize that readopting this presumption will result in some imprecision in amounts presumptively allowable as expenses. We think, however, that this treatment strikes a balance that falls within the range of reasonableness allowed in setting rates, and strikes a more reasonable and less burdensome balance than requiring a Commission determination of whether every antitrust settlement carriers might claim in the ratemaking process was in the public interest. This treatment also acknowledges that lawsuits may be frivolous or unfounded and gives carriers leeway to dispose of such suits without incurring additional burdens at the Commission. Furthermore, it avoids creating any additional incentive for carriers' adversaries to use antitrust allegations for leverage against carriers.

45. To receive recognition of its avoided costs of litigation, a carrier must demonstrate, in a request for special relief, the avoided costs of litigation by showing the amount corresponding to the additional litigation expenses discounted to present value, that the carrier reasonably estimates it would have paid if it had not settled. Settlement costs in excess of the avoided costs of litigation are presumed not recoverable unless a carrier rebuts that presumption by showing the basic factors that induced the carrier to settle and demonstrating that ratepayers benefited from the settlement.
Carriers should make any showings in a request for special relief rather than with the tariff filing.
Upon making such a showing, the carrier would receive credit in the ratemaking process for the portion of the settlement costs allocated to the interstate jurisdiction under Part 36 of the Commission's Rules, 47 C.F.R. Part 36. We make no determination about the portion of those

settlement costs that would be assigned to the intrastate jurisdiction and, additionally, we will not require the ILECs to make any exogenous adjustments to their price cap indexes because of these rule changes.

46. A carrier requesting recovery of the avoided costs of litigation must accompany its request with clear and convincing evidence that, without the settlement, it would have incurred the expenses it estimates. The evidence will, of course, vary according to the circumstances. Among the data a carrier may provide are any available cost estimates provided by the law firm representing the carrier, an estimate of attorney hours needed to complete the case along with the hourly rates for the attorneys involved, information regarding the discovery remaining to be completed, the amount of trial time scheduled by the judge, and information regarding the number of witnesses or documents that would have been introduced at trial, including any pretrial statements filed with the court, costs of expert witnesses, travel time, saved in-house counsel replacement costs, and any other material the carrier considers relevant. The avoided costs of litigation of a pre-judgment settlement would include the anticipated costs of litigating until a judgment. The avoided cost of litigation of a post-judgment settlement would anticipate a successful appeal in the particular case.

47. The Pacific Companies have asked how to treat settlements in cases involving multiple claims and settlements. Such settlements can include both monetary and nonmonetary terms in a multiple count case. Carriers should state how they propose to allocate settlement costs between antitrust and other causes of action in their settlement agreements. Only the settlement costs attributed to antitrust claims will be subject to the rules and policies adopted in this Order. The accounting treatment of matters that would ordinarily be treated as operating costs should not change because these matters have been raised in complaints also alleging antitrust violations. We recognize that adversaries may add antitrust allegations to otherwise commercial disputes if they perceive an opportunity for gaining an advantage because of the operation of the Commission's accounting rules and ratemaking presumptions. We caution carriers, however, that this allocation should not attempt to circumvent the Commission's intention that antitrust settlements are presumed to be disallowed in the ratemaking process absent a showing of ratepayer benefit, and we remind carriers that they must make a showing to justify the allocation of costs to the various causes of

action contained in a settlement.

D. Litigation Defense Costs

48. For several years the Commission has questioned whether ratepayers should bear the expenses of defending antitrust litigation when a carrier is found to have violated the antitrust laws. In both Litigation Costs Proceeding and Litton Accounting Proceeding, the Commission concluded that ratepayers should not, and directed carriers to recapture the defense costs recorded in operating accounts by transferring them to a nonoperating account. The court reviewing the rulemaking decision agreed that the Commission could establish a presumption against recovery of litigation expenses in situations where it was legally permitted to create such a presumption with respect to judgments and settlements. It questioned the Commission's decision to recover, in the year in which they were incurred, litigation expenses initially booked above the line but subsequently disallowed because of an adverse judgment. The court criticized the decision because the Commission failed to explain why recapturing expenses does not constitute retroactive ratemaking. The court reviewing Litton Accounting Proceeding rejected the Commission's use of recapture, faulting the Commission for failing to consider factors other than simply whether an antitrust violation occurred and whether the carrier succeeded or failed in the litigation. The court stated that the Commission should have examined the reasonableness of allowing recovery for the litigation expenses even though an adverse antitrust judgment was issued against the carriers. The court also stated that the Commission inadequately explained the reasons for its policy change from permitting to denying recovery of litigation expenses.

49. The NPRM addressed the retroactive ratemaking question raised in Litigation Costs Decision by proposing that carriers should accrue antitrust litigation expenses in a balance sheet deferral account until the underlying antitrust litigation is resolved. If the result is a final adverse judgment or a post-judgment settlement, the expenses would be entered in Account 7370, the same account used for the underlying judgment or settlement. If the carrier prevails or enters into a pre-judgment settlement, however, the expenses would be amortized above the line. The NPRMrecognized that dicta in Litton Accounting Appeal contain language unfavorable to the proposal, but observed that the proposed result was not precluded by the court if accompanied by a sufficient rationale.

50. This proposal drew considerable opposition. Although MCI and Rafferty generally support it, the remaining commenters offer many reasons why it would be both bad accounting and bad policy. Commenters emphasize that adopting the proposal will impose significant direct costs on carriers to screen and track every lawsuit for antitrust allegations. Even if the actual number of such allegations is small, the burden will not be. This will create artificial incentives for competitors to threaten or assert antitrust claims for strategic advantage, leverage, or an undeserved settlement. Commenters assert that lawsuits often are complicated by multiple causes of action, multiple defendants, amended complaints, and piecemeal resolution of issues. Commenters also make other arguments in opposition. First, COMSAT claims that expenses must be incurred before there has been any finding of illegal conduct, and recovery later is based entirely on the outcome of litigation, without any consideration of the carrier's prudence in incurring the litigation expenses. Yet, carriers have a right to defend themselves and the business they operate. Second, BellSouth argues that deferral accounting is onerous because investors must bear the full cost of ongoing litigation while it is pending, without assurance of future cost recovery in an increasingly competitive environment. One result may be a higher cost of capital in order to compensate shareholders for their increased risk. Third, several commenters state that deferral accounting is inconsistent with generally accepted accounting principles (GAAP), which the Commission's accounting rules seek to require under the competitive model. Other commenters assert that the proposal will unfairly distort the earnings for sharing purposes of price cap carriers, shift the burden or benefit of the outcome of litigation to future ratepayers, distort financial results over time, and discourage aggressive competition. Finally, four commenters note that a similar proposal was considered and abandoned by the Commission as unworkable.

51. BellSouth's alternative suggestion, that the balance in the deferral account be included in the rate base during the pendency of the litigation illustrates the difficulty in deviating from the use of an operating account for operating expenses. BellSouth argues that it should be allowed to charge the principal balance to operating expense upon successful termination of the litigation. Typically, the rate base includes items related to the company's capital investment, such as land, leases, equipment, and interest on funds borrowed to finance capital investment. Capital investment

not yet used and useful for the carrier's business are carried in a deferral account until brought into service, although interest on debt related to the capital investment could be included in the rate base in the interim. BellSouth's proposal would capitalize litigation expenses. BellSouth's second alternative suggestion, that the carrier be able to charge interest for the deferred litigation expenses to an operating account upon successful termination of litigation, may compensate the carrier partially for the delay in recovering costs, but would exacerbate the distortions to earnings for sharing purposes.

52. After careful consideration of the comments, we conclude that we should not adopt our earlier proposal to require the ILECs to record litigation expenses in a deferral account and, after an adverse judgment, record them below-the-line. Rather, we conclude that we should allow all litigation defense costs to continue to be recorded in operating accounts. Although this is a departure from our previously adopted rule, an important part of our regulatory effort has been to eliminate, when possible, and always to minimize, costs imposed by regulation that burden one competitor more than another. Our proposal could create some incentive for adversaries to bring antitrust suits or add antitrust claims to otherwise normal business litigation. Ratepayers, whom we sought to protect from unnecessary costs, would still bear much of the expense of tracking litigation costs. These factors, as well as the potential distortions to reported earnings, cause us to conclude that the public interest is better served by retaining the status quo. Although the costs of defending litigation will continue to be accounted for as operating expenses, the Commission may still request data about such expenses.

E. Other Types of Litigation

53. The Commission tentatively concluded in the NPRM that its litigation cost rules should also apply to state antitrust lawsuits and to lawsuits involving the violation of other federal statutes where the actions giving rise to the litigation did not benefit ratepayers. We proposed to implement the latter with either case-by-case review of lawsuits involving judgments or settlements exceeding some threshold amount or by compiling a list of federal statutes for which it can reasonably be assumed that actions in violation of the statute did not benefit ratepayers. Neither a threshold amount nor a tentative list of statutes was proposed.

54. The Commission's previous attempt to extend litigation cost rules to violations of federal statutes beyond antitrust was reversed in Litigation Costs Decision because the Commission had not justified the application of its rules to costs incurred in non-antitrust lawsuits. All of the commenters addressing this proposal, except MCI, argue that the Commission still has not provided a justification and that rational implementation would be virtually impossible. Carriers remind us of the wide variety of laws they encounter in their business, including environmental, tax, securities, employment, and occupational and safety laws, and argue that violations likely occur because of what a carrier might consider a reasonable interpretation of the law and one from which the ratepayers might have benefited. According to USTA:

> The Commission lacks the ability and the resources to determine, for example, whether the level of preservative historically used in telephone poles should be viewed as environmentally appropriate in the future, whether a carrier's decisions among alternative ways to dispose of lead cable sheathing are prudent, or whether choices among alternative methods to notify customers of rules contemplated by other agencies are cost effective in light of the requirements eventually adopted. All of these have been real situations confronted by both exchange and interexchange carriers . . . .

BellSouth argues that compiling a list of statutes is impossible, because the reasonableness of the carrier's conduct when it made the decision leading to the violation, not the fact of the violation of any particular statute, is the test for determining whether the ratepayers benefited. No carriers other than MCI suggest statutes other than antitrust for which a violation could be presumed not to benefit ratepayers.

55. The Pacific Companies agree with the Commission that state antitrust actions can be treated consistently with federal antitrust litigation costs, but only if the Commission clearly defines what is meant by state antitrust action. Because state unfair competition statutes vary from state to state and many include business torts, which the Commission treats as ordinary expenses, simply extending the litigation cost rules to state antitrust statutes may not give carriers clear enough

guidance about how they are to record judgments and settlements in state litigation.

56. Upon further analysis, we conclude that we should not extend application of the rules adopted in this Order to govern accounting treatment of judgments and settlements beyond costs associated with federal antitrust lawsuits. We have inadequate information about state antitrust laws and did not intend to perform ad hoc analyses of the consistency between state and federal antitrust laws. We also have no basis on this record to presume that conduct violating any other federal statutes "could not, at the time it was undertaken, reasonably be expected to produce a net benefit to ratepayers." The court reminds us that what "the ratepayers would have decided in their own economic self-interest" would be a "right" decision, even if it turned out to be wrong after the law was interpreted. The few examples of possible violations the record contains, found in the USTA Comments, support this analysis. Thus, for violations other than federal antitrust violations, we will retain the existing presumption applying to all litigation costs; i.e., that they arise out of events occurring in the normal course of providing service to ratepayers, and that ratepayers benefit from provision of service. MCI argues that we should use litigation cost rules to provide carriers with an economic incentive to obey federal laws, but our authority is limited to implementing the Communications Act of 1934, as amended. We are authorized to consider violations of other laws only to the extent that they directly bear on our responsibility to ensure just and reasonable rates, not because we have broad, general responsibility to ensure the public interest.

57. MCI recommends that the Commission extend litigation cost rules to violations of the Communications Act so that carriers cannot recover from ratepayers any expenses incurred in cases brought by ratepayers to redress a carrier's Communications Act violation. We have concluded that we should not presumptively deny recovery of the costs of judgments and settlements in lawsuits, with no exception for litigation before this agency. Proceedings before an agency regulating a carrier's business seem to be directly related to the carrier's business. This is not to say that the costs of judgments and settlements in proceedings alleging a violation of the Communications Act may always be recovered from ratepayers, but only that the record in this proceeding does not justify erecting a presumption against recovery. Ratepayers believing that the

costs in any proceeding are "illegal, duplicative, or unnecessary" or otherwise excludable should
make these assertions during the proceeding or in a complaint about rates.

F. Interim Action

58. In the NPRM, the Commission "require[d] carriers to record any antitrust judgments and settlements incurred during this interim period in Account 1439, Deferred charges." The Commission contemplated that, upon completion of the rulemaking, the carriers would be allowed to treat the expenses in accordance with the new rules. BellSouth and COMSAT strongly object to this direction, which BellSouth views as retroactive rulemaking, retroactive ratemaking, and a violation of the six-month notice requirement of 47 U.S.C. § 220(g) and COMSAT views as unauthorized because the previous rules were vacated in Litigation Costs Decision.

59. Now that we have resolved this rulemaking, entries deferred in Account 1439 for antitrust judgments and settlements must be removed to the appropriate account. We advised carriers in the NPRM that they would have to reclassify these costs once the rules on litigation costs were finalized. In accordance with these requirements, carriers should clear Account 1439 of these entries by moving them to Account 7370 when the rules adopted in this proceeding become effective in accordance with Section 220(g) of the Communications Act. Carriers seeking ratemaking recognition of these costs should make an appropriate filing demonstrating how ratepayers benefited. We disagree with BellSouth that this approach constitutes retroactive ratemaking any more than transferring these charges to an operating account would, because this action does not have as its purpose compensating for past charges that resulted in excessive or inadequate earnings. Rather, this action accomplishes an accounting correction, required to move the entries to the correct account.

60. We also disagree that the Commission's interim action improperly constitutes retroactive rulemaking, because the Commission did not seek to change past accounting entries with the interim rule. Rather, the interim rule became effective thirty days after publication of the NPRM in the Federal Register and applied prospectively to "antitrust judgments and settlements incurred in the interim period." This distinguishes the interim action in this proceeding from the invalid retroactive attempt to recoup monies previously paid in Bowen, on which BellSouth relies. The Commission had good cause for the interim action because of its concern that, without litigation cost rules in place, carriers could recover from ratepayers judgments and settlements that should not

properly be borne by ratepayers during the period of the rulemaking. Absent interim action, charges to ratepayers for judgments and settlements during the interim period could not be recouped without raising questions about retroactive ratemaking and retroactive rulemaking. Rather than requiring carriers to account for judgments and settlements in accordance with the rulemaking proposal or to report and address judgments and settlements in ratemaking proceedings arising during the interim, the Commission fashioned a neutral remedy that would defer accounting for the disputed sums pending the resolution of the rulemaking. This is consistent with Mid-Tex Electric Co-op. in which interim FERC rules governing construction work-in-progress were affirmed. The interim rules in that case were similar to ones approved in substantial measure by the court but vacated because FERC had failed to consider anticompetitive consequences, and were fashioned to address the court's concerns while that commission conducted the rulemaking.

VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

61. In the NPRM, the Commission certified that the rules it proposed to adopt in this proceeding would not have a significant economic impact on a substantial number of small entities because the proposed rules did not pertain to small entities. No comments were received specifically concerning the proposed certification. However, some comments were received generally concerning the impact of the proposed rules on small entities. For the reasons stated below, we certify that the rules adopted herein will not have a significant economic impact on a substantial number of small entities. This certification conforms to the Regulatory Flexibility Act ("RFA"), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA").

62. The NPRM certified that no regulatory flexibility analysis was required because the entities affected by the proposed rules were either large corporations, affiliates of such corporations, or were dominant in their field of operations and therefore not small entities. However, the rules we adopt in this Report and Order apply to all carriers providing interstate services, some of which may be small entities. Moreover, since the NPRM, we have stated that although we still consider small incumbent LECs to be dominant in their field of operations, we now include such companies in our regulatory flexibility analyses. Consequently, we cannot certify that no regulatory

flexibility analysis is required for the reasons offered in the Notice.

63. Nonetheless, we still certify that no regulatory flexibility analysis is necessary here. As the two parties commenting on small entity issues observed, it is unlikely that a substantial number of small LECs will be subject to federal antitrust litigation. Consequently, it does not appear that the rules will affect a substantial number of small entities. Even if a substantial number of small entities were affected by the rules, there would not be a significant economic impact on those entities. These rules govern the accounting treatment of federal antitrust judgments and settlements in excess of the avoid costs of litigation, but not for litigation expenses. BellSouth, in commenting on small entity issues, contended that the proposed rule which would have required all carriers, including small, to accrue litigation costs in a separate account and record them below the line if the carrier lost its legal action, would be unduly burdensome on small LECs. This Report and Order does not adopt that proposal, thereby eliminating this concern.

64. We therefore certify pursuant to section 605(b) of the RFA that the rules adopted in this order will not have a significant economic impact on a substantial number of small entities. The Commission will publish this certification in the Federal Register, and will provide a copy of the certification to the Chief Counsel for Advocacy of the SBA. The Commission will also include the certification in the report to Congress pursuant to the SBREFA.

VII. ORDERING CLAUSES

65. Accordingly, IT IS ORDERED, that pursuant to sections 4(i), 219 and 220 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i), 219 and 220, Part 32 of the Commission's Rules IS REVISED as set forth in the Appendix below, effective six months after the date of publication of this Order in the Federal Register.

66. IT IS FURTHER ORDERED, that consistent with this Order, carriers SHALL TRANSFER interim entries of antitrust settlements and judgments from Account 1439 to Account 7370, effective six months after the date of publication of this Order in the Federal Register.

67. IT IS FURTHER ORDERED, that the Secretary SHALL SERVE a copy of this Order on each state commission.

68. IT IS FURTHER ORDERED that the Secretary shall send a copy of this Report and

Order including the Final Regulatory Flexibility Analysis, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 605(b) of the Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. §§ 601 et seq. (1981).

69. IT IS FURTHER ORDERED, that the Secretary SHALL CAUSE a summary of this Order to be published in the Federal Register.

70. IT IS FURTHER ORDERED, the collections of information contained within are contingent upon approval by the Office of Management and Budget.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary

APPENDIX

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

1. The authority citation for Part 32 continues to read as follows:

Authority: 47 U.S.C. 154, 47 U.S.C. 219, 220.

2. Section 32.7370 is amended by revising paragraph (d) to read as follows:

§32.7370 Special charges.

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(d) Penalties and fines paid on account of violations of statutes. This account shall also include penalties and fines paid on account of violations of U.S. antitrust statutes, including judgments and payments in settlement of civil and criminal suits alleging such violations; and

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