APPENDIX - DERIVATION OF THE ALLOCATION FACTORS FOR PACIFIC BELL AND NEVADA BELL

The allocation factor is derived based on the following procedure:

(1) Service Cost is determined individually by Company.

(2) The remainder of the PBOP expense is allocated by the percentage of each Company's APBO to the total APBO. These percentages are 96% and 2% for Pacific Bell and Nevada Bell, respectively, during the projection period.

(3) The total allocation factor is derived by dividing the sum of (1) and (2) by the total PBOP expense. The allocation ratios for Pacific Bell and Nevada Bell are 96% and 2%, respectively.

Components of total PBOP expense which are asset-related can not be calculated individually by Company, since the assets of the trust fund can not be separately identified by Company.

Appendix 8

Testimony of John M. Bertko

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the matter of post-retirement benefits other than pensions.	I.90-07-037 (Filed July 18, 1990)
Application of Pacific Gas and Electric Company for authority among other things, to increase its rates and charges for electric and gas service. (Electric and Gas) (U-39-M)	Application 88-12-005 (Filed December 5, 1988)
And Related Matter.	I.89-03-033 (Filed March 20, 1989)

TESTIMONY OF JOHN M. BERTKO

ON BEHALF OF PACIFIC BELL (U 1001 C)

IN RESPONSE TO

ORDERING PARAGRAPHS 5 AND 6 OF I.90-07-037

August 30, 1991

PREPARED TESTIMONY OF JOHN M. BERTKO

1. Q. What is your name and business address?

   A. My name is John M. Bertko, and my business address is Coopers & Lybrand ("C&L") , 333 Market Street, San Francisco, California 94105.

2. Q. By whom and in what capacity are you employed?

   A. I am a partner with the Actuarial, Benefits and Compensation Consulting Group of Coopers & Lybrand and am in charge of health and welfare benefits consulting services for the San Francisco office. I am also the senior h lth actuary in Coopers & Lybrand.

3. Q. What is the purpose of your testimony in the proceeding?

   A. I have been retained by Pacific Bell ("Pacific") to provide expert actuarial testimony regarding Pacific's response to the California Public Utilities Commission ("CPUC") on Postretirement Benefits Other than Pensions ("PBOP") with respect to certain questions raised in Order Instituting Investigation 90-07-037 ("OII"). In that capacity, I have reviewed the work of Pacific's staff actuary, the actuarial methods used for both the funding and the accounting calculations, the assumptions chosen for the liability and expense calculations, the supporting data and how those calculations would be used in connection with Financial Accounting Standard No. 106

("FAS 106"). I am also sponsoring the Summary and response to OII Question 1 of Pacific's Phase II Comments.

4. Q. Please describe your educational background.

A. I graduated from Case Western Reserve University in May 1971 with a Bachelor of Science Degree in Mathematics.

5. Q. Please describe your professional experience.

A. I became a Fellow of the Society of Actuaries in 1981. I also became a Member of the American Academy of Actuaries in 1981 and am an Enrolled Actuary, qualified to practice under the Employee Retirement Income Security Act ("ERISA").I have approximately 11 years of experience with Coopers & Lybrand as a consulting actuary. Prior to joining C&L in 1980, I was employed as an actuary by the Metropolitan Life Insurance Company.

While at C&L, I have had both local and national responsibility for developing and managing our PBOP consulting practice. As the senior health care actuary in the firm, I was the lead actuary on the Financial Executives Research Foundation Field Test of the FASB Exposure Draft on accounting for PBOPs. Because of the potential significant impact of the new accounting standard, the Financial Executives Institute engaged Coopers & Lybrand to design and perform a comprehensive study of the effects of proposed standard (i.e., the

Exposure Draft) on the financial statements of large companies. Twenty-five of the nation's largest companies participated in the Field Test, representing a mixture of industrial, service and financial services companies across the country.

I had overall responsibility for directing the research and managing the Field Test project. C&L staff worked closely with the participating companies to obtain benefit plan, demographic and claims data and to assess the limitations of the data available. We then performed extensive actuarial modeling of the Exposure Draft rules as well as several alternative accounting rules. I was a co-author of the results of the study which were published as a book, Retiree Health Benefits: Field Test of the FASB Proposal.

As part of my work on the Field Test, I had extensive contact with the Financial Accounting Standards Board ("FASB") and its project staff. This included both informal meetings with the FASB and testimony before formal meetings of the Board in their offices.

On a professional level, during 1989 and 1990 I served as Chairman of the Retiree Health Benefits Subcommittee of the American Academy of Actuaries. In that capacity, I drafted the actuarial profession's response to the

FASB Exposure Draft and worked directly with the FASB staff during 1990 to offer technical advice during the period when the FASB completed its deliberations on FAS 106. I also presented the views of the Academy at the FASB's hearings in Washington, D.C. in November 1990.

I also was elected to the Health Section Council of the Society of Actuaries and served as faculty this spring for professional education seminars on FAS 106 compliance issues for actuaries.

6. Q. Please summarize your opinion of the calculations performed by Pacific's actuaries.

A. Based on my extensive review of the work performed by Pacific's actuaries, I believe that the expense and obligation are calculated using generally accepted actuarial methods and are appropriate for use in estimating FAS 106 financial statement information. Further, the actuarial contributions developed to determine the voluntary employees' beneficiary association ("VEBA") funding levels also follow appropriate methods and are consistent with my understanding of the applicable sections of the Internal Revenue Code ("IRC").

My review included examination of the supporting data, the assumptions employed, and the actuarial computer model used by Pacific's actuaries. I also checked the results for reasonableness and reviewed sample participant calculations to assure myself that the calculations were appropriate.

7. Q. Was an Actuarial Report produced for PBOPs?

A. Yes. Attached is the Actuarial Report for Phase II of the OII for Pacific Bell and Pacific Telesis Group PBOPs (Medical, Dental and Group Term Life Insurance) which provides an actuarial valuation projected to 1993. It was prepared by Pacific Telesis Group actuaries.

8. Q. Has C&L performed any studies that examine how companies react to FAS 106?

A. Yes. C&L surveyed employers as part of a study for the National Association of Accountants.

9. Q. Please describe the results and purpose of C&L's recent study of how companies are reacting to FAS 106.

A. As part of a large study for the National Association of Accountants, Coopers & Lybrand surveyed 383 employers regarding retiree health benefits. The purpose of the study was to help management better understand the new accounting regulations of FAS 106 and to review potential implementation problems. Of the 383 responding employers, 112 provided retiree health or life insurance benefits. Although the survey was completed in 1990 prior to the publication of FAS 106, 42 of the 112 companies had already measured their PBOP obligation. Of the 42 companies, 34 companies were measuring the obligation for financial reporting purposes. Nearly all of those companies with a measurement (29) had followed the Exposure Draft rules.

This result supports the belief that many companies with PBOP obligations are already preparing for compliance with the new FAS 106 rules.

10. Q. **What actuarial calculations are required for analysis of the impact of FAS 106?**

A. Analysis of PBOP obligations under FAS 106 requires projections of the retiree population each year into the future along with the expected benefit payment for each retiree and dependent in each of those years. This process starts with deriving the "baseline cost" from the current average per capita cost and the current plan population and then requires projections of future cashflows using assumptions to estimate the effect of health care cost trends, plan provisions and population changes (e.g., aging, retirement and turnover). After the cashflows have been estimated, each year's payment is discounted back to the current year to obtain the "actuarial present value" of those future benefit payments. The sum of the present values for all future years is the present value of the whole benefit obligation, which is called the Expected Postretirement Benefit Obligation ("EPBO") under FAS 106.

In order to calculate the portion of the obligation already earned, FAS 106 defines a portion of the EPBO as the Accumulated Postretirement Benefit Obligation ("APBO"). The APBO includes the full obligation for participants already retired and for active employees who have fully satisfied eligibility requirements (e.g., active employees with 30 years of service) and a pro rata portion of the obligation for other employees. The APBO will be disclosed in financial statement footnotes when FAS 106 is implemented and is used in the calculation of the amortization and "interest" portions of financial statement expense.

To calculate the annual financial statement expense, the company's actuary must calculate several items including:

- o Amortization of the transition obligation, which is the amount of the APBO which is not either funded or accrued as of the date when FAS 106 is implemented;
- o Interest on the APBO;
- o Service cost, which is the pro rata portion of the EPBO earned by active employees during the current year;

- Amortization of gains and losses and prior service costs; and
- Earnings on assets (which are used to reduce expense).

The sum of these items must be recognized by a company on its income statement. Upon implementation, this expense, less benefit payments and FAS 106 assets, is accrued as an obligation on a company's balance sheet. During that time while the transition obligation is being amortized, expense will be "level" if actual experience matches actuarial assumptions.

11. Q. What elements of Pacific's actuarial calculations did you review?

A. Based on my experience in reviewing over 100 PBOP Exposure Draft and FAS 106 valuations, I worked with Pacific's actuaries to review all of the critical components of their calculations. These components included the following:

- Plan provisions,
- Baseline costs,
- Initial number of participants,
- Economic assumptions, including
  - Health care cost trend
  - Underlying inflation rates

- Interest (discount) rate
- Expected long-term rate of return on plan assets

o Demographic assumptions, including
- Retirement rates
- Mortality rates
- Turnover rates
- Dependent enrollment

o Methodology used in the actuarial computer models,

o Review of sample retiree calculations, and

o Review of results for reasonableness.

In the course of the examination, I reviewed documentation for each of these critical areas. My review of the choice of assumptions is summarized in later questions.

As part of this process, I reviewed Pacific's actuarial computer model. It is common practice to employ an established actuarial projection program to produce the necessary PBOP estimates. Pacific's actuaries used a program developed by a major actuarial consulting firm in this role and my analysis shows the results to be reasonable.

Because PBOP work is still relatively new to many actuaries (in contrast to pension projects), I further tested the calculations of Pacific's actuaries by reviewing the calculation of the obligation for "sample" Pacific participants. This is a common review technique which allows an experienced actuary to check the application of actuarial assumptions, formulas, baseline costs and calculations. I found that Pacific's actuaries had used generally accepted actuarial practices to calculate appropriate estimates.

I also performed reasonableness checks of Pacific's overall PBOP results. By comparing several per employee and per retiree estimates with estimates from other companies, a reviewing actuary can uncover any unusual results or errors. After extensively evaluating the estimates of Pacific's actuaries I concluded that the actuarial estimates for obligation and expense were calculated in an appropriate manner.

12. Q. What are the most significant factors determining the amount of Pacific's PBOP obligation?

A. Similar to most companies, there are four factors which are derived from Pacific's own circumstances which are most important in determining Pacific's obligation:

a. The number of participants, including retirees, dependents and active employees;

b. The plan provisions which define the benefits for participants,

c. The starting "baseline cost" which is unique to any group of individuals, and

d. The health care cost trend assumption.

Other assumptions, such as interest (discount) rate, retirement rates and turnover rates, are also important but will be similar for many employers. The critical factors listed above are likely to be unique to Pacific's circumstances and will be the primary determinants of the amount of the obligation.

a. Number of participants

As a mature company, Pacific has a relatively high ratio of retirees to active employees with 32,570 retirees and 58,228 active employees for a ratio of 1 retiree to 1.8 active employees (these are 12/31/89 numbers and are reflected in the attached actuarial report).

b. Plan provisions

Plan provisions determine the actual cash payments which will be made in the future for retiree health and group term life insurance benefits. As part of its history as one of the "Baby Bell" regional operating companies, one component of Pacific's total compensation package is a wide range of benefits. These benefits are very similar to the other large telephone utilities and to benefits of AT&T. These benefits include health care benefits with a lifetime maximum that in the near term is unlikely to affect benefit payments.

Pacific has implemented several "managed care" programs for both active employees and retirees to provide incentives for participants to use less expensive "preferred providers" and, like several other large telephone utilities, has negotiated a maximum annual company contribution for hourly bargaining unit employees which is scheduled to become effective 1/1/93. The maximum annual contribution has also been applied to managers.

c. Starting "baseline cost"

For a company with a large group of retirees like Pacific, the "baseline cost" can be determined directly from the claims experience of the retiree group, adjusted for any known changes in plan provisions. It is important to analyze both the current per capita retiree claim cost and the company-specific rate at which cost increases by age (the "claims cost curve").

I reviewed the analysis performed by Pacific's actuaries and administrative staff on the 1989 incurred claims cost for the group of current retirees. These per capita costs were used to develop a claims cost curve for projection of future costs. Based on my extensive experience in researching and reviewing actuarial projection methods for PBOPs, I found this methodology to be among the most advanced actuarial method available today.

As an indication of the cost for today's retirees, the average claim cost for retirees at age 60 is $2,434 for a male and $2,291 for a female and for a retiree age 65 (after Medicare becomes the primary payor) the cost is $678 for a male and $620 for a female (these are for pre 1/1/87 retirees who are under the Medical Expense Plan). Because most of Pacific's retirees live in California which is a high health care cost region, these amounts are relatively high compared with costs of other companies in other regions.

d. Medical care cost trend rate

The medical care cost trend rate assumption ("trend rate") is one of the most important assumptions used in calculating PBOP obligations. As used with FAS 106 calculations, the trend rate should be a measure of the rate of change of gross eligible charges incurred by retirees and their dependents. The trend rate includes inflation (i.e., increase in unit prices), changes in intensity of service and utilization and technological changes.

Change in benefit payments due to aging are specifically excluded from the trend rate because the actuarial projection model explicitly "ages" participants. For each future year, a participant is assigned a per capita cost which is based both on his or her age and on the number of years that costs are projected from the valuation date.

My review included a thorough examination of the development of the trend rate assumption and the linkage to other economic assumptions, such as the discount rate and the underlying general inflation and real productivity growth rates. Upon examination, I found that Pacific had clear historic support for high (but not uncommon) short term trend rates of 12% to 14% in the period from 1990-1993.

These rates then decreased at a relatively quick rate starting in 1994 to a long term trend rate of 6% from the year 2002 forward. Based on Pacific's overall economic forecasts for general inflation and real productivity growth, the long term trend rate is similar to most other large companies. Because Pacific's projections use the long term trend rate by the year 2002 (rather than assuming a more gradual decline in trend rates), this calculation of Pacific's obligation is likely to be lower than a similar calculation by other companies using a longer period to reach the long term trend rate. In summary, Pacific's trend rates are reasonable, supported by historic data and are similar to rates used by other companies for FAS 106 purposes.

Because of different circumstances and experience, dental trend rates are assumed to remain level at 4% for the actuarial projection. Upon review I found that this is an appropriate trend rate.

13. Q. What is the basis for the other assumptions used by Pacific's actuaries for the calculation of the PBOP obligation?

A. The interest (discount) rate is a significant assumption for calculating the actuarial present value of future benefit payments. This was chosen to be 8-1/2% to be consistent with the definition of the discount rate required by FAS 106. Although FAS 106 defines the discount rate in slightly different terms from FAS 87 for pension plans, if the payment stream is similar, then the assumed discount rate for both FAS 87 and FAS 106 would be the same.

The expected long-term rate of return on plan assets (8.5%) should reflect the average rate of earnings expected on plan assets. This assumption is used with the actual plan assets in Pacific's VEBA to compute the expected return on plan assets used in the calculation of plan expense.

Other important assumptions include: rates of retirement, turnover, mortality and dependent enrollment. Pacific's actuaries based these assumptions on post-divestiture experience of Pacific itself, taking into account the changes in the company's workforce.

14. Q. **Was there a significant change between the FASB's Exposure Draft issued February, 1989 and the final statement (FAS 106) issued December, 1990?**

A. **Yes.**

15. Q. **Please explain.**

A. In response to significant criticism from the employer community, the FASB modified its final standard to require companies to account for PBOP benefits under the "substantive plan" rather than the "written plan". Under the Exposure Draft which required the "written plan", employers would be able to assume only the terms as presently set forth in their respective plans. However, in plain language, companies are now required under FAS 106 to accrue a best estimate for their PBOP obligation. Because of the extended period for projecting PBOP benefits, it is highly unlikely that the plan, as written, will remain unchanged over that entire period.

16. Q. Did Pacific reflect the substantive plan in its PBOP liability calculation?

A. Yes. In Pacific's case, the company has negotiated a medical contribution cap for retiree benefits beginning with contributions due on or after January 1, 1993 for participants who retire on or after January 1, 1991. However, the provisions of the written plan do not provide for any inflationary increases for future years. Therefore, pursuant to FAS 106's substantive plan concept, Pacific estimated its future obligation using realistic projections of future expense.

17. Q. Are Pacific's substantive plan assumptions reasonable and appropriate?

A. Yes. Pacific realizes that there may be adjustments made in future periods. The use of the substantive plan has a significant effect on the calculation of the PBOP obligation. Accordingly, the portion of likely future cost increases should be accrued.

18. Q. Do the calculations of the FAS 106 obligation and related expense and revenue requirements performed by Pacific conform to generally accepted actuarial principles?

A. Yes. I have reviewed the actuarial methods used, the actuarial assumptions chosen by Pacific, the starting baseline costs and sample calculations. As a result of my review, I believe that the calculations and projections performed by Pacific's actuaries conform with generally accepted actuarial principles for estimating FAS 106 obligations and expense for Postretirement Benefits Other than Pensions. Pacific's actuarial report provides the summary of assumptions, methods and results which document the development of the results.

19. Q. **What are the major differences between PBOP calculations used for accounting purposes and those used for determining funding levels?**

A. The actuarial method used for determining the appropriate accounting expense and obligation under FAS 106 is prescribed in the standard as the "Projected Unit Credit" method. Under the accounting rules, annual expense is determined as a sum of the current accrual (or earned benefit) for active employees plus an interest accrual on the past service obligation and an amortization of the transition obligation (i.e., the unfunded and unaccrued past service obligation at the date of implementation). A company has no options regarding use of another type of actuarial method.

For determining funding levels, a company must abide by IRC constraints but is free to choose from any acceptable actuarial funding method. Since there are several methods that provide higher initial tax deductible funding levels, many companies choose these methods. In the absence of IRC constraints, many actuarial funding methods will give similar answers for PBOPs since most benefits are not related to salary.

The major difference between actuarially determined funding levels and accounting expense is the requirement under IRC rules for non-bargained plans to limit projections to "current" (non-inflated) costs rather than the more realistic costs used in accounting calculations. It is my understanding that these IRC constraints were imposed by Congress in response to perceived abuses of the prior IRC rules. The changes in the tax code produced drastic and artificial limitations on the amounts which could be deducted.

20. Q. Please describe the funding method utilized for Pacific's bargained VEBA?

A. The bargained VEBA trust calculation is developed in a similar manner to the FAS 106 calculations. Since there are different requirements under IRC Sections 419 and 501(c)(9), the funding calculation is based on a different actuarial funding method.

In many areas, the calculation of the VEBA requirement uses the same methods for developing baseline costs, choosing actuarial assumptions and projecting the total obligation (known under FAS 106 as the EPBO). The major differences emerge in the calculation of the past service liability (which is a defined partition of the total obligation) and the development of an annual funding (or expense) amount.

Pacific's actuaries are currently using the Individual Level Premium method to develop the funding amount. This method is one of the six accepted actuarial funding methods for developing contribution amounts for any future actuarial obligation. The only constraints required by the Internal Revenue Code for bargained VEBAs are that the amounts be reasonable for the liability and that funding be done on an actuarially level basis. Based on my review, Pacific's calculations of the funding amounts comply with my understanding of the applicable regulations and rules.

21. Q. What is your conclusion upon examination of Pacific's actuarial numbers prepared for implementation of FAS 106?

A. Based on my review, it is my opinion that the actuarial methodology, assumptions and calculations performed by Pacific's actuaries are appropriate for use in implementation of FAS 106 for Postretirement Benefits Other than Pensions and for determining appropriate funding levels for VEBA contributions.

22. Q. Does this complete your prepared testimony?

A. Yes, it does.

CERTIFICATE OF SERVICE

I, C. A. Helms, hereby certify that copies of the foregoing "Direct Case of Pacific Bell and Nevada Bell", re CC Docket No. 92-101, were served by hand or by first-class United States mail, postage prepaid, upon the parties on the attached Service List on this 1st day of June, 1992.

By: ______________________
C. A. Helms

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