APPENDIX 1

UNITED STATES

TELEPHONE ASSOCIATION

Analysis of Impact of

FAS 106 Costs on GNP-PI

February, 1992

Godwins

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BACKGROUND

Godwins has been engaged by the United States Telephone Association to perform an analysis of the impact of SFAS 106 on the GNP-PI. In particular, Godwins was asked to determine the extent to which the price cap mechanism utilized by the FCC will reflect the impact of SFAS 106 and will enable Local Exchange Carriers to recover their increase in total operating costs incurred due to their adoption of the new accounting standard.

This report describes the results of that analysis and provides detailed documentation of the data, methods, and assumptions utilized in the study.

Respectfully submitted,

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I. EXECUTIVE SUMMARY

The purpose of this study is to determine what percentage of the additional costs incurred by Local Exchange Carriers subject to Federal Price Cap regulations (hereinafter referred to as "Price Cap LECs") as a result of the Financial Accounting Standards Board's Statement No. 106 (SFAS 106) will be reflected in the GNP Price Index (GNP-PI) and what percentage will not be so reflected.

This study finds that ultimately the increase in GNP-PI caused by SFAS 106 (.0124%) will provide for recovery of 0.7% of the additional costs incurred by Price Cap LECs. Other macroeconomic factors, principally an eventual adjustment of the national wage rate, account for recovery of an additional 14.5% of the additional costs incurred by Price Cap LECs, leaving 84.8% of these additional costs unrecovered.

This study is presented in two stages: an Actuarial Analysis followed by a Macroeconomic Analysis. The Actuarial Analysis uses demographic, economic and benefit program data collected from each Price Cap LEC to construct a composite company (hereinafter referred to as "TELCO") which reflects the characteristics of the industry as a whole. This analysis finds that the impact of SFAS 106 on the costs of the average employer in the economy is only 28.3% of the corresponding impact on TELCO. The Macroeconomic Analysis which analyzes the impact of SFAS 106 on the economy as a whole finds that only 2.3% of the average employer's additional costs resulting from SFAS 106 is passed through to the GNP-PI.

The table on the following page summarizes how the key results of the study are combined to derive the unrecovered proportion of the Price Cap LECs' SFAS 106 costs.

Effects of SFAS 106 on TELCO's Costs

(A)	Impact on national average costs relative to TELCO's costs (from the Actuarial Analysis)	28.3%
(B)	Proportion of increase in national average costs passed through to GNP-PI (from the Macroeconomic Analysis)	2.3%
(C)	Proportion of TELCO's SFAS 106 cost increase reflected in GNP-PI (item (A) x item (B))	0.7%
(D)	Proportion of TELCO's SFAS 106 cost increase offset by other macroeconomic adjustments, including the reduction of the wage rate (from the Macroeconomic Analysis)	14.5%
(E)	Proportion of TELCO's SFAS 106 cost increase unrecovered (100% - item (C) - item (D))	84.8%

Actuarial Analysis

Even if one were to take a conservative approach and assume that all SFAS 106 costs were passed through directly and completely to price increases and thus into the GNP-PI, 100% of each Price Cap LEC's SFAS 106 costs would be reflected in the GNP-PI, only if the following were true:

- The benefits provided by the Price Cap LEC to its employees were at the same level as those provided to all other employees in the economy.

- The benefits provided by the Price Cap LEC gave rise to the same relative increase in total costs as for other employers when SFAS 106 is applied.

Because neither of the above statements is true, the percentage of each Price Cap LEC's SFAS 106 costs that will be reflected in the GNP-PI is far less than 100%. Indeed, we have determined that ignoring macroeconomic effects, only 28.3% of the additional costs incurred by the average Price Cap LEC due to SFAS 106 would be reflected in the GNP-PI. This result was derived by the following steps:

- By utilizing demographic, economic, and benefit program data collected from each Price Cap LEC we constructed a composite company (hereinafter referred to as "TELCO") which reflects the characteristics of the industry as a whole.

- By utilizing a data base of plan provisions for retiree medical plans sponsored by 830 private sector employers (covering 19 million employees) and our Benefit Level Indicator ("BLI") methodology, we determined how TELCO's program compared to a "national average" benefit program.

- We adjusted this comparative benefit analysis to reflect specific factors that would cause similar benefit programs to generate different levels of SFAS 106 cost. In particular, we adjusted for:

  - differences in demography (average age, service, etc.)
  - differences in withdrawal and retirement patterns
  - differences in the number and impact of current retirees
  - differences in the extent of current pre-funding of benefits conducted by TELCO and that of others.

- We then took account of the very large group of workers in the national economy who are not covered by any post-retirement program or are covered by a program that is not affected by the FASB's rules. Their employers will, by definition, incur no SFAS 106 cost for them.

- We made two final adjustments to the comparative analysis due to economic factors. In particular, we:

  - made an adjustment for differences between per unit labor costs for TELCO and for other employers, and

  - made an adjustment for differences in the percentage of total output represented by labor costs for TELCO and for other employers.

Putting together all of these factors, we find that the impact of SFAS 106 on the costs of the average employer in the economy (including employers that do not offer post-retirement health benefits and/or are not affected by FASB's rules) is only 28.3% of the corresponding impact on TELCO. In addition, the Actuarial Analysis finds that SFAS 106 directly increases labor costs by 3% for the average employer offering post-retirement health benefits covered by SFAS 106. This 3% figure is an important input to the Macroeconomic Analysis.

Macroeconomic Analysis

The purpose of the Macroeconomic Analysis is to determine the extent to which the additional costs resulting from SFAS 106 would be passed through to an increase in GNP-PI. The Macroeconomic Analysis utilizes a macroeconomic model developed for Godwins by Professor Andrew Abel of the Wharton School of the University of Pennsylvania to address this question. The Macroeconomic Analysis finds that only 2.3% of direct SFAS 106 costs of the average employer in the economy are passed through to the GNP-PI. In addition, as a result of SFAS 106 the average wage rate in the economy would be 0.93% lower than it would have been in the absence of SFAS 106.

Effects of SFAS 106 on TELCO's Costs

As noted, the ultimate purpose of the study is to determine the extent to which GNP-PI reflects the additional costs incurred by the average Price Cap LEC (i.e. TELCO) as a result of SFAS 106. The table shown on page 2 summarizes our findings. Item (A) summarizes the Actuarial Analysis which finds that costs of

the average company in the economy increase by only 28.3% as much as TELCO's costs increase as a result of SFAS 106. Because only 2.3% of the average increase in costs is passed through to the GNP-PI (item (B)), only 0.7% (item (C), 2.3% x 28.3%) of TELCO's additional costs resulting from SFAS 106 are reflected in GNP-PI. Thus, it would appear that 99.3% of TELCO's additional costs are left unrecovered. However, the Macroeconomic Analysis finds that the national wage rate would eventually be 0.93% lower than it would have been in the absence of SFAS 106. If TELCO were able to benefit from a similar reduction in its wage rate, such a reduction would recover an additional 14.5% of TELCO's direct SFAS 106 costs (item (D)). Taking account of the 0.7% recovery due to GNP-PI and the eventual 14.5% recovery due to the adjustment of the wage rate leaves 84.8% of TELCO's direct SFAS 106 costs unrecovered (item (E)).

II

II. DEVELOPMENT AND SUMMARY OF RESULTS

We wish to establish what percentage of the average Price Cap LEC's SFAS 106 costs will be reflected in the GNP-PI and hence what percentage will not be so reflected.

We begin with an actuarial analysis which proceeds in two steps. The first step in the actuarial analysis is to construct a composite company which accurately reflects the characteristics and benefit plans of the average Price Cap LEC. The second step is to determine the impact of SFAS 106 on this composite company relative to the impact of SFAS 106 on other employers in the GNP on the assumption that all additional costs are passed on completely into the GNP-PI. Following the actuarial analysis is a macroeconomic analysis to determine the extent to which the additional costs will, in fact, translate into higher prices and, therefore, affect the GNP-PI.

Construction of Composite Company ("TELCO")

Actuarial, benefit, economic and demographic data were collected on eleven Price Cap LECs. Data included was for total Telephone Operations consistent with amounts included on the 1990 ARMIS 43-02 for each Company. These data were then combined, treating each Price Cap LEC as if it were a division of the larger combined company. The characteristics of this composite company ("TELCO") are as follows:

Number of Active employees	613,193
Number of Retired employees:	294,482
1990 Average compensation per employee:	$38,533
1990 Total Revenue (in millions):	$82,512.9
1990 Total Value Added (in millions):	$61,338.4
Average Per Capita Claims Cost:	$3,075
Average Age of Actives:	41.6
Average Service of Actives:	16.6

Impact of SFAS 106 on the Average Price Cap LEC Relative to its Impact on All Employers in the GNP

There are 95.8 million private sector employees and 18.6 million public sector employees in 'GNP', all of whom (and their dependents) may incur medical charges in retirement. Public sector employers, however, will not record SFAS 106 expense even where the entity sponsors a post-retirement medical plan (public sector employers are not subject to FASB rules).

Of the private sector employees, 30.7 million are eligible to have a proportion of their charges in retirement met by their employer's medical plan (and which plan is subject to SFAS 106), the actual proportion depending on the detailed provisions of their employer's plan(s). It is this anticipated employer cost for those employees that is reflected in SFAS 106 costs. The proportion of the charges met is an effective measure of the overall level of benefit provided by a given plan. We will refer to it as the Benefit Level Indicator ("BLI"). We must establish the average proportion of covered employees' charges that will be met collectively by their employers - the GNP BLI.

Separately we will calculate the average proportion of charges met by the average Price Cap LEC - the TELCO BLI.

All other factors being equal (which they are not), the percentage of TELCO's SFAS 106 costs that would be reflected in the GNP-PI would be represented by the following ratio:

$$\text{BLI Ratio} = \frac{\text{GNP BLI}}{\text{TELCO BLI}} = \frac{\text{Benefit Level Indicator for the average employer in the GNP}}{\text{Benefit Level Indicator for TELCO}}$$

However, this ratio requires a number of adjustments:

- Adjustment for differences in demography which will affect the SFAS 106 impact of a given program (Demographic Adjustment).

- Adjustment for the differing impact on SFAS 106 costs of current retirees at TELCO compared with other employers (Current Retiree Adjustment).

- Adjustment for any differences in the extent to which TELCO is pre-funding its post-retirement benefits compared to other employers (Pre-Funding Adjustment).

- Adjustment for employees not covered by post-retirement medical programs or covered by programs for which SFAS 106 will not apply (Non-Covered Employees Adjustment).

- Adjustment for differences between per unit labor costs for TELCO and for other employers (Per Unit Labor Cost Adjustment).

- Adjustment for differences in the percentage of total output represented by labor costs for TELCO and for other employers (Labor Cost Percentage Adjustment).

Utilizing the data, methods, and assumptions described in Section III, we have determined the following values:

(1) GNP BLI = .2568

(2) TELCO BLI = .4390

(3) BLI Ratio = .2568 ÷ .4390 = <u>.5850</u>

(4) Demographic Adjustment = .5438

(5) Current Retiree Adjustment = .9287

(6) Pre-Funding Adjustment = 1.313

(7) Non-Covered Employees Adjustment = .2684

(8) Per Unit Labor Cost Adjustment = 1.3062

(9) Labor Cost Percentage Adjustment = 2.0832

(10) SFAS 106 Cost Increase Ratio = BLI Ratio x (4) x (5) x (6) x (7) x (8) x (9) = .2833

The SFAS 106 Cost Increase Ratio can be interpreted as meaning that, at most, only 28.3% of the additional cost incurred by TELCO due to SFAS 106 will find its way into the GNP-PI because the average employer in the GNP will experience only 28.3% of the cost increase that will hit TELCO.

Extent to which Impact of SFAS 106 on All Employers in GNP Translates into an Increase in the GNP-PI

The effect of SFAS 106 on the GNP-PI is calculated using a macroeconomic model that has two sectors. In sector 1 employers do not offer post-retirement health benefits, and in sector 2 employers do offer post-retirement health benefits. The macroeconomic model treats the introduction of SFAS 106 as a direct increase in the cost of labor facing employers in sector 2. The baseline calculations using the model calculate the impact of SFAS 106 on the GNP-PI using the following information:

(1) sector 2 accounts for 32% of private sector employment;

(2) labor costs account for 64% of total costs in sector 1 and in sector 2; and

(3) SFAS 106 directly increases labor costs by 3% in sector 2.

Based on these inputs, numerical solution of the macroeconomic model indicates that SFAS 106 will increase the private sector price index by 0.0138%.

To put this result in perspective we calculate a back-of-the-envelope estimate of the effect of SFAS 106 on the private sector price index as follows: a 3% increase in labor costs raises total costs and prices in sector 2 by 1.92% (64%

share of labor costs in total costs x 3% increase in labor costs) and thus raises the private sector price index by 0.614% (1.92% increase in price in sector 2 x 0.32 share of sector 2 in private sector GNP). Thus, if all direct costs were completely passed through in prices, and if there were no change in the amount of labor employed and output produced by each employer, the private sector price index would increase by 0.614%. However, taking account of the impact of labor costs on the demand for labor, and the impact of price changes on the demand for goods, the macroeconomic model finds that the private sector price index increases by only 0.0138%. We define the "passthrough coefficient" as the increase in the price index according to the macroeconomic model divided by the back-of-the-envelope price increase. In the baseline calculation, the passthrough coefficient is 0.0225 (0.0138% ÷ 0.614%). The passthrough coefficient can be thought of as the percentage of national SFAS 106 costs that will actually be reflected in the private sector price index.

The GNP-PI covers prices of government sector production as well as prices of private sector production, with the government sector accounting for 10.6% of GNP and the private sector accounting for 89.4% of GNP. Because SFAS 106 does not apply to the government sector, the government component of the GNP-PI will not be affected by SFAS 106. Therefore the increase in the GNP-PI equals 89.4% of the increase in the private sector price index. This factor of 89.4% applies both to the back-of-the-envelope price increase and to the price increase calculated by the macroeconomic model. Thus, the back-of-the-envelope increase in the GNP-PI is 0.549% (0.894 x 0.614%) and the increase in the GNP-PI according to the macroeconomic model is 0.0124% (0.894 x 0.0138%). The passthrough coefficient is 0.0225 (0.0124% ÷ 0.549%) which is identical to the passthrough coefficient for the private sector price index.

<u>Resulting Impact of SFAS 106 on TELCO Relative to its Overall Impact on the GNP-PI</u>

As noted above, the average employer in the GNP will experience only 28.3% of the cost increase that TELCO will experience due to SFAS 106. Furthermore, we have seen that only 2.3% of the cost increase experienced by all employers in the GNP will be passed through to the GNP-PI. From the interaction of these factors we

are able to conclude that only 0.7% of TELCO's SFAS 106 costs will be reflected in the GNP-PI and that 99.3% of these additional costs will not be reflected in this price index.

Additional Macroeconomic Effect of SFAS 106

In addition to the result reported above our macroeconomic model indicates that, in response to the impact of SFAS 106, the wage rate in the national economy will, over time, reduce in relative terms by 0.93% (i.e., relative to what it would have been in the absence of SFAS 106). To the extent that TELCO could also benefit from a relative reduction in its wage rate this would help to offset its increase in costs due to SFAS 106. If TELCO were able to achieve the full reduction of 0.93% this would finance 14.5% of its additional SFAS 106 costs. As noted, this wage rate reduction reflects the ultimate effect of SFAS 106 and would not necessarily fully occur in 1993 when SFAS 106 becomes effective.

Thus the combined effect of the impact of SFAS 106 on the GNP-PI and on the wage rate would still leave 84.8% of TELCO's additional SFAS 106 costs unrecovered.

III

III. DETAILED DESCRIPTION OF ANALYSIS

Impact of SFAS 106 on the Average Price Cap LEC Relative to its Impact on All Employers in the GNP

This section of our report is a re-iteration of Section II but with considerably more detail.

Construction of Composite Company ("TELCO")

As noted earlier, eleven Price Cap LECs submitted data for this study. Each firm informed us of its number of active employees and their average ages and average service, and of the number of its retirees covered by employer subsidized Medical Plans. We were also provided detailed descriptions of the Medical Plans for Retired Employees and of the results of actuarial studies of the impact of SFAS 106 on expensing for these Plans.

Our data included a distribution by quinquenial age and service cells for 125,000 active employees, and we used the shape of this distribution for the valuations needed for this report. The distribution was shifted as required, to fit the known average age and average service for all of the Price Cap LECs. A census was constructed from the adjusted distribution, which census represents the typical Price Cap LEC.

A Benefit Level Indicator was determined for each Plan. As noted earlier, this Benefit Level Indicator measures the relative value of individual plans. The methodology for calculating the Benefit Level Indicator for a given retiree medical plan is discussed in detail beginning on page 12. The Indicators were averaged and a Plan with the average Benefit Level Indicator was used for this study. As expected, the actuarial assumptions used for the calculation of the impact of SFAS 106 differed from study to study.

The discount rate was a single number for all but 1 of the 11 Price Cap LECs (an equivalent uniform rate was proffered for the one exception) and the discount rate for the composite firm, TELCO, was taken as the average of the individual rates, weighted by number of active employees. Simple averages could not be used for turnover assumptions or retirement decrements because such rates are one or two dimensional arrays. Therefore TELCO turnover was derived by doing valuations of a standard Plan using each firm's turnover rates, the TELCO census, and a standard retirement age. The turnover table for TELCO was taken from a collection of standard turnover tables used for Pension Valuations, and was selected as that table which when used with the TELCO census, standard Plan and standard retirement age gave the best agreement as to the SFAS 106 liabilities as determined by the aggregation of individual firm's actuarial studies.

The composite retirement age assumption for TELCO was derived by setting a pattern for each firm, which pattern gave the same average retirement age for an employee attaining age 55, ignoring mortality, as given by the retirement age assumptions used for the actuarial studies. These patterns had one free parameter (the level rate to be applied for ages 55 to 61), and the composite pattern was that pattern with the average value of the free parameter. TELCO's trend rates were derived using an analysis similar to that used for determining TELCO's retirement rates. We used an ultimate trend rate equal to the average of ultimate trends rates used in the actuarial studies. We then determined a value for an initial trend rate for each Price Cap LEC such that a declining pattern of trend rates beginning with that initial trend rate and grading down to the average ultimate trend rate gave the same present value for a 30-year stream of projected claims payments as would be obtained by using the actual trend rates assumed in that Price Cap LEC's actuarial study. The composite trend assumption for TELCO was the pattern associated with the average initial trend rate grading down to the previously determined average ultimate trend rate.

Calculation of GNP BLI and TELCO BLI

We define the Benefit Level Indicator ("BLI") to mean the percentage of total medical claims incurred by an employer's retirees that will be reimbursed by the employer's benefit program. This definition applies only to the plan for which the employer's active employees may become eligible and the BLIs are based only on current levels of medical costs and Medicare reimbursement. We consider only current levels because the SFAS 106 requirement to value the "substantive" plan suggests that it is reasonable to assume that plan provisions (e.g., deductibles, out-of-pocket maximums, etc.) will generally be projected (either explicitly or implicitly) to stay consistent with aggregate cost levels. In general, the liability for current retirees is already being expensed on a pay-as-you-go basis and is a function of prior plan provisions. As noted earlier, the impact of current retirees on SFAS 106 costs is taken account of in the Current Retiree Adjustment.

Thus, in order to calculate the BLI of a given employer's post-retirement medical plan one needs the plan provisions and an anticipated frequency distribution of medical charges broken down by type of charge and size of charge.

The calculation itself is very detailed, but relatively straight forward. For each type and size of annual claim pre- and post-65 (e.g., hospital charges between $5,000 and $6,000 incurred before age 65), the plan's provisions (i.e., deductible, coinsurance, etc.) are applied and a plan reimbursement amount is calculated, allowing for any integration with Medicare benefits.

After all plan reimbursement amounts are calculated, the frequency distribution is applied to calculate an overall average reimbursement ratio compared to total medical charges. This ratio is then adjusted for the amount of required retiree contributions called for by the plan. The result is the net BLI. Because of the significant differences between plan provisions that apply to retirees pre- and post-65 (Medicare integration, contribution levels, etc.), two BLIs are calculated, pre- and post-65. These two BLIs are then weighted to generate an overall BLI for the employer.

As noted above, the calculation of an employer's BLI requires both a data base of employer plan provisions and a detailed medical claims distribution. With respect to plan provisions, we have utilized a data base of over 1,000 employers which includes 830 employers who sponsor post-retirement medical programs. For each of these employers, we have detailed plan provisions which include for pre- and post-65 coverage for each type of medical charge (surgery, hospital, physicians, drugs, etc.):

- Eligibility requirements
- Deductible
- Coinsurance
- Out-of-pocket maximums
- Plan reimbursement maximums (annual and lifetime)
- Required contributions for employee and dependent coverage
- Type of Medicare Integration

The data base includes only limited information on dental coverage and no information on post-retirement life insurance. The data base itself is comprised mostly of large employers with over 1,000 employees and is distributed throughout all six of the major industry categories outlined by the General Accounting Office in its recent survey of the prevalence of post-retirement medical programs. In total, the data base covers approximately 19 million of the estimated 38 million employees who work for employers who sponsor post-retirement medical programs. A summary of the data base appears in Appendix A.

With respect to the distribution of medical claims, we utilized a distribution based on the actual 1990 experience of 39,436 retirees (pre- and post-65) covered by employer sponsored post-retirement medical plans administered by one large national insurance company. The data includes detailed breakdowns of claim amounts by size and type of claim. It covers plans throughout the United States and, to our knowledge, does not have any geographic or industry bias.

To derive GNP-BLI, Benefit Level Indicators were calculated for each employer in the data base, then a comparison was made between our data base of large employer plans and the employers who make up the GNP. In making that comparison, we

utilized information from the United States General Accounting Office March 1990 Report on "Extent of Companies Retiree Health Coverage", including unpublished supporting data obtained directly from the GAO staff. In particular, average BLIs by industry (weighted by number of employees) were determined from our data base. These average BLIs were then weighted by the percentages of covered employees working in each major industry as determined by the GAO survey. These weighted values were then averaged to come up with BLIs for the GNP for pre-65 and post-65 coverage separately. The pre- and post-65 BLIs were then weighted, based on the average demographics and retirement experience of the national workforce, to produce GNP-BLI.

TELCO in total sponsors 18 post-retirement medical programs (i.e. one or more for each of the Price Cap LECs). The same BLI calculation process described above was utilized to determine the pre- and post-65 Benefit Level Indicators for each of the 18 employee groups. These 18 sets of BLIs were then combined on an employee weighted basis to derive pre- and post-65 BLIs for TELCO as a whole. The pre- and post-65 BLIs were then weighted and combined on the basis of national average demographics and retirement patterns to produce TELCO BLI. The numerical derivation of GNP BLI and TELCO BLI is outlined below.

Calculation of Benefit Level Indicator for Average Employer in GNP

1. Calculate pre- and post-65 BLIs by industry from data base.

Industry	*Pre-65 BLI*	*Post-65 BLI*
Mining & Manufacturing, etc.	*.7232*	*.2340*
Construction	*.7758*	*.0604*
Transportation/Utilities	*.7974*	*.2643*
Retail	*.4730*	*.0603*
Finance/Insurance	*.6721*	*.1926*
Consumer Services	*.5771*	*.1267*

2. Calculate industry weighted average BLIs using industry weightings from GAO study. (See Appendix A for industry weightings from GAO study)

Industry Weighted Average BLI Pre-65	=	*.6898*
Post-65	=	*.2008*

3. Calculate GNP BLI based on national demographics (retirement age = 63). (See Appendix B for methodology for determination of pre- and post-65 weightings)

GNP BLI = .2568

Calculation of Benefit Level Indicator for TELCO

1. Calculate pre- and post-65 BLIs for each plan sponsored by TELCO:

Weighted Average Benefit Level Indicators for TELCO

Pre-65	=	.8295
Post-65	=	.3885

2. Calculate TELCO BLI based on national demographics:

TELCO BLI = .4390

Calculation of Demographic Adjustment

Even if the Benefit Level indicators of the GNP were equal to that of the average Price Cap LEC (i.e. if GNP BLI were equal to TELCO BLI), they would not necessarily generate the same anticipated retiree claim cost per active employee. If TELCO employees exhibit different turnover than other employees in the GNP, a different percentage of TELCO's employees will reach retirement. This will result in a different retiree claim cost per active employee. As can be seen from Appendix A, TELCO will in fact utilize lower rates of turnover than those