The Appendix references for FAS 71 clearly note that it may be applied to accounting effects other than the specific effects that were the subject of a pronouncement in December 1982 when the Statement was issued. "If the regulated enterprise changes accounting methods and the change does not affect costs that are allowable for ratemaking purposes, the regulated enterprise would apply the change in the same manner as would an unregulated enterprise."[51] If most unregulated enterprises will explicitly reflect their actuarial estimates of FAS 106 effects only on their balance sheets, but only implicitly reflect PBOPs in their long run prices, the Commission's denial of an exogenous adjustment for FAS 106 would effectively "apply the change in the same manner" as contemplated by FAS 71. In short, the existence of a "cost-plus" sector of the economy is a major factual contention which NERA should have tried to prove — not simply assume.

However, even if the NERA report had provided a factual basis for its supposition about a "cost-plus" sector of the economy, and even if one accepts the premise that the FCC intended to pass-on such changes via exogenous adjustments — a premise entirely at odds with the Commission's statements discussed above — the NERA report is so flawed that it can contribute nothing substantive or useful to the FAS 106 debate. Flaws in the NERA report, individually and cumulatively, demonstrate that the FCC should give no consideration to the NERA report. These include:

1. NERA erroneously (and incredibly) assumes that a 1.96% increase in the prices of their "cost plus" sector which accounts for some 10% of GNP would have no effect on prices of the other sectors in the economy. This would have a definite impact on GNPPI both in the current and continuing years as the price increases flowed through the economy.

2. NERA advocates changing prices that were used in the development of the 3.3 productivity offset; this would require adjustment of all of the data used in Appendix C of the *LEC Price Caps Order* and productivity offset.

3. NERA provides no econometric or statistical estimates of the effect of implementation of FAS 106, or any parameter estimates, summary statistics, or assessments of the forecast accuracy of any model. Thus the burden of proof referenced in paragraph 16 of the Order is clearly not met.

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51. FAS 71, Appendix B, paragraph 31.

4. NERA ignores the fact that if FAS 106 costs can be passed on directly to ratepayers in the cost plus sector, all employers (and their bargaining units) in the cost plus sector would migrate toward 100% PBOP coverage in the entire cost plus sector. This would have the effect of increasing requests for additional exogenous treatment in future years and would certainly create an additional increment to US inflation rates, especially in the health care area at just the time when national policy is to slow such inflation.

5. Last, but perhaps not least, NERA erroneously develops and proclaims universal a "theory of price cap regulation" in order to promote its own price cap views. The Commission should not rely on any aspect of this presumptuous mathematical exercise.

NERA erroneously assumes that a 1.96% price increase in 10% of GNP will have little or no effect on GNPPI. In the NERA view, there are two sectors of the economy: the cost plus sector is comprised of telecommunications, railroads, passenger transit, non-gas pipelines, electric/gas/water, and government contractors. The "other" sector is comprised of all other firms. Table 1, page 30, of the report shows that the cost-plus sector is about 10.49% of US GNP. In one of their scenarios, NERA's authors entertain the possibility that all cost plus firms increase costs by 1.92%. Their calculation of the overall effect on the price level, say GNPPI, is a final increase of 0.2% [52].

Does this make sense? Although their multiplication is fine, the report missed a rather large economic effect. The "other" sector, the non-"cost plus" firms all buy heavily from the industries shown above, especially telecommunications. Since these business would incur 1.96% price increases using NERA's scenario under exogenous treatment of FAS 106, these "other" sector firms would have cost increases some of which they would pass on to the ultimate customers. Of course all of this inflation would eventually work its way into the GNPPI and the LECs would be afforded another opportunity to increase prices. Where did NERA's analysis go wrong? For onething, the report assumed that the "other" sector buys nothing at all from the cost plus sector. Examination of the industries in that sector make it clear that this assumption is absurd.

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52. See their calculations in footnote 33 of the NERA Report.

Economists generally discuss such effects in input-output models[53]; somehow this issue was totally ignored by NERA.

NERA advocates changing prices that were used in the development of the 3.3 productivity offset; this would require adjustment of all of the data used to develop the LEC price caps formulae. One of NERA's arguments is that "Prices under price caps were initially set using cash accounting for postretirement benefits. Thus a change in the price cap is necessary so that prices will reflect the economic cost of service."[54] The bottom line of their argument is that prices used by the FCC were wrong and should be adjusted. If the prices were wrong, then all of the analysis of Appendix C by Frentrup and Uretsky in the *LEC Price Caps Order* is wrong and the calculation of the 3.3% and 4.3% offsets are in error.

This is even further confused by the VEBA expenses recorded by Pacific in the pre-price caps time period. These numbers, by definition, affected data used to develop the 3.3% productivity offset.

If the FCC accepts NERA's argument, then the whole price cap formula must be re-analyzed and recalculated (especially the productivity offset) in order to be consistent. We believe that the FCC does not wish to re-litigate the issues in Docket 87-313 again. In order to be consistent, the request for exogenous treatment of PBOP's must be denied.

No econometric or statistical estimates of the magnitudes involved are presented; rather it provides a simplistic "back of the envelope" calculation. In contrast to the USTA report, which developed a useless and complicated economic model with invented numerical parameters, NERA presents an overly simplified calculation based on 3 numbers.[55] When energy price increases occurred, realistic econometric models are able to show the effects on overall inflation and many sectors of the economy. The same is true of various tax changes, money supply changes, and other similar economic effects. These kinds of effects are typically analyzed with the help of an econometric model of the economy. NERA has explicitly chosen not to analyze the effects of FAS 106 in this way.

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53. See, for example, A. Chaing, *Fundamental Methods of Mathematical Economics*, Third Edition, New York: McGraw-Hill, 1988.

54. NERA Report, page 2.

55. NERA Report, pp. 26-27.

It is not possible to believe that the effects of FAS 106, if there is any effect at all, can be analyzed with three numbers.

The Report ignores effects of the proposed exogenous treatment on the extent of PBOPs. NERA completely ignores the fact that if PBOP costs can be passed on directly to ratepayers in the cost plus sector, that all employers (and their bargaining units) in the cost plus sector would migrate toward 100% PBOP coverage in the entire cost plus sector. This would have the effect of increasing health care cost inflation which would certainly create an additional increment to US inflation rates. At the same time telecommunications carriers would file requests for additional exogenous treatment in future years. This would, if accepted by the regulators, create substantial price effects.

Why would this occur? Suppose a telecommunications carrier offers two kinds of compensation to its employees: cash wages and PBOPs. The employee rightly considers both as compensation and places value on both components. If FAS 106 is afforded exogenous treatment under price caps, the employer can pass on directly to the ratepayers the PBOP differentials claimed by the LECs. Thus there is an incentive by the employer to increase PBOP coverage because it is far less costly to the employer than increases in cash wages which can not be passed on at all. The employer could then petition state commissions for "exogenous treatment". NERA completely ignores this effect which would encourage "cost-plus" behavior in an incentive regulation program which has the opposite objective.

Finally, *NERA erroneously develops an incorrect "theory of price cap regulation" which it uses to promote the LECs' biased price cap views.* In large sections of its report, NERA attempts to lend weight to its argument by including numerous pages of mathematics of a "theory of price cap regulation".[56] These 10 pages of equations do not support their position and in fact have some serious flaws. For example, the report continues to rely on equation (1) on page 7 to discuss productivity even though it assumes that the company's rate of return is constant over the time period of the analysis. This assumption is obviously incorrect as noted in testimony filed in Docket 87-313.[57]

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56. Pages 5-9, and Appendix, pages 1-4.

57. See, for example, page 12 of "Technical and Data Errors in the FCC's Productivity Analysis", Attachment B, *Comments in Response to Supplemental Notice of Proposed Rulemaking*, Ad Hoc Telecommunications Users Committee, May 7, 1990, Docket CC-87-313.

In fact, NERA's facts and formulas are inconsistent with their own analysis of Pacific Bell's experience in California. In Docket 87-313, this same approach led Bellcore and, later, NERA to conclude that telephone industry differential productivity growth averaged 2% or less per year and that this number should be used in the FCC's price cap formula. At the same time, Pacific Bell (and GTE California) also argued that no "productivity" offset any higher than 2% should be approved in the price caps component of the California PUC's "new regulatory framework" (NRF). The California Commission adopted a 4.5% offset.[58]Now, however, Pacific Bell has requested a continuation of its 4.5% total factor productivity (TFP) growth in its California intrastate Incentive Regulation Plan called New Regulatory Framework (NRF). NERA's own conclusion is:

> By themselves, Pacific's earnings during the NRF do not suggest that a productivity target of 4.5 percent is either significantly too high or too low. While not reaching the sharing level, Pacific's earnings were consistent with an average productivity achievement over the period within the range contemplated in the Commission's Decision.[59]

The formulas which misled NERA in Docket 87-313 should not now be used to justify PBOP exogenous treatment. Overall, the NERA approach has numerous serious flaws which render it useless for estimating the effects of FAS 106 on GNPPI and the LECs, even if one assumed that it was appropriate to make such an exogenous adjustment. The FCC should give the NERA report no weight in its analysis of the LECs' claim.

IV. Conclusion

The local exchange carrier industry's efforts to have FAS 106 accounting changes applied as an exogenous Z-adjustment to the ceilings for their interstate price cap rates should be rejected by the Commission. Exogenous treatment of these accounting effects would be a very bad policy choice. The entire context of the Commission's Price Cap plan for LECs is to eliminate regulatory issues of precisely the types raised by the FAS 106 issue. The LECs' FAS 106 "cost" estimates are built upon a series of assumptions that is impossible for the FCC or any other entity to accurately audit. Granting exogenous treatment to FAS 106 effects would turn price caps into purely a "heads-we-win, tails-you-lose" for monopoly telephone companies.

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58. Re: Alternative Regulatory Frameworks, *Decision 89-10-031*, October 12, 1989.

59. William E. Taylor and Timothy J. Tardiff, NERA, "The New Regulatory Framework 1990-1992: An Economic Review" , May, 1992, page 29.

In addition to the core policy issue raised by the proposals, we have now shown conclusively that the data and studies used to support the LECs' tariff filings and the direct cases does not accurately reflect the economic consequences of Postretirement benefits. Estimates of FAS 106 accounting effects are based upon actuarial forecasts and techniques that may not have been fully tested by the accounting profession, for telephone companies or, indeed, for other US firms. There is no supervening requirement that would provide an independent check upon these estimates because PBOPs are not governed by a separate regulatory statute, unlike Pension Plans that are regulated under ERISA. The carriers' analyses ignore the extent to which PBOP liabilities were reflected in the share prices of the LEC and other firms evaluated by the FCC for the rate of return represcription upon which the LEC price cap plan was based. Given the amount of data that was available for the modelling efforts noted above, the Commission should fairly conclude that FAS 106 effects already are discounted to some degree in the existing nationwide average rate of return prescribed for all carriers. The LECs submissions also would ignore the inter-relationships between employee compensation and benefits, including PBOPs, and the savings that would occur through the employee reduction plans now underway. Such offsetting efficiencies can continue to occur in the future, as the Price Cap plan was designed to encourage. Finally, we have shown that the "models" of the overall economic effects of FAS 106 are simplistic and inaccurate and contain assumptions about methods, data and forecasting that are not correct.

TABLE A FCC Docket 92-101
COMPARISONS OF LEC DATA IN DIRECT CASES (1)

DATA ITEM	AMER	BATL	BSTC	GTE	NYNX	PACB	SNET	SWB	UNITED	USWC
Basis:			[VEBA]		[VEBA]	[VEBA]	[VEBA]			
OPEB 1991		404.4	142.4			181.3				366.0
OPEB 1992		418.6	157.5			192.1				
OPEB 1993			210			102.6			78.4	432
PAYGO 91	50.3	302.0	38.8	14.4		104.2	18.5		14.8	107.0
PAYGO 92	51.8	302.0	46.5	18.8		119.5	26.1		13.9	
PAYGO 93			26						15.6	121.6
OTHER						280.6				
Cost different.		116.6	184							310.4
					AVG					
1993 Interstate r/r		20.3		65.0		25.4	2.0		3.9	19.0
PCAP-start r/r					73.0	34.0				59.3
Discount rate	7.5%	8.0%	9.0%	8.0%	8.5%	5.0% a/t		7.5%		8.5%
Ret. on plan assets	N/A	8.0%	8.0%	8.0%	9.0%	8.5%		7.5%		0.0%
INFLATION										
PRE 65 (unless noted)	-ALL-				TREND	IN-NET				-ALL-
Start year	1991		1993	1991	1991		1992	1992		1991
rate	10.0%		11.0%	15.0%	15.0%	12.0%	11.4%	14.0%		9.0%
			1995							
			13.0%							
Stop year	2000		2007	2000	2011		1994	2000		2000
rate	6.4%		7.0%	6.0%	4.0%	6.0%	9.9%	6.0%		8.0%
POST-65					INFL/s					
Start year	"		1993	1992	1991		1992	1992		"
rate	"		4.0%	10.0%	9.0%		5.0%	13.0%		"
	"		1995							"
	"		5.2%							"
Stop year	"		1996	1997	2011		1994	1997		"
rate	"		5.0%	6.0%	4.0%		8.1%	9.0%		"
PAY INCREASES/YR				6.0%			5.0%			
RETIREMENT RATE				HIST			1973-77			1975-78
	data not	data not				sel '91				
TERMINATION RATE	sourced	sourced	1975-85	HIST		exper.	1975-78			1975-78
MORTALITY	1983		1980-85							
			1976-83							

Note 1: This table is not intended to show each data point for each LEC in a strictly comparable manner, because different carriers reported data in various ways. Some data are incremental in nature while other are absolute numbers. The table is used simply to compare differences in certain LECs' estimates. where comparable and to note the wide differences submitted in LEC direct cases.