

many LEC employees are represented by labor unions that bargain for wages and benefits with GTE management. Plainly, management does not have autonomy in determining the level or mix of wages and benefits.

### **3. LECs Have Incentive To Control Costs**

Ad Hoc expressed a concern that, "Categorizing costs associated with the implementation of SFAS-106 as exogenous could well prove a disincentive to controlling the costs of OPEB and the delivery of those benefits in an efficient manner."<sup>30</sup>

GTE management has in the past and will in the future seek to control costs. Under price caps, GTE has clearly assumed the responsibility to manage this rising level of expenses without a guaranteed revenue offset from the Commission, as was previously available under rate of return regulation.

Due to incentive regulation, GTE and other price cap LECs are incented to mitigate expense increases. GTE is provided the incentive to effectively manage and control its operational costs and fails to see how the granting of full recovery of OPEBs would change this incentive.

GTE continues to look for the least expensive method of providing health care benefits. The Company has already aggressively pursued cost savings measures, such as: the utilization of retiree contributions, Health Maintenance Organizations (HMOs), Preferred Provider Organizations (PPOs) and

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<sup>30</sup> Ad Hoc at 15.

Patient Advocate. Other areas addressed to reduce overall medical cost include improving plan administration efficiency, medical plan redesign, internal health promotion and disease prevention programs. The Company has also carefully scrutinized other cost saving alternatives, and will continue to do so.

Not to be overlooked, however, is the fact that GTE has only partial control over the level of these benefits and costs. While employers can exercise control over salary costs, the costs of OPEBs are influenced by certain factors outside the control of the employer. Health care inflation has a dramatic impact on the long-term cost of OPEBs plans. Additionally, while GTE has some degree of control over medical benefits covered under a plan, the utilization of specific coverages or procedures, the costs involved are generally beyond GTE's control. Plans typically are coordinated with Medicare benefits and a company has no control over future changes in the Medicare laws.

**F. THE EXOGENOUS ADJUSTMENT SHOULD NOT BE LIMITED TO AMOUNTS PREFUNDED**

AT&T maintains that, "To be eligible for exogenous treatment, the Commission should require the LECs to prefund the permissible accrual amount to ensure that amounts paid by ratepayers are used only for the purpose for which exogenous treatment was granted."<sup>31</sup> AT&T also believes that, "a requirement should be established that limits the amount to be

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<sup>31</sup> AT&T at 14.

considered to the amount that the carrier actually prefunds, less any amounts already reflected in their price cap indexes, whether funded or not."<sup>32</sup>

Before GTE addresses these issues, it will be necessary to clarify terminology. In the following paragraphs the term "prefunding" will be used to describe the funding of the OPEBs liability prior to adoption of SFAS-106. The term "funding" will be used to describe funding the OPEBs liability after the adoption of SFAS-106.

As presented in GTE's direct case (Attachment IV) the Company has actively pursued prefunding the OPEBs liability through the use of Collectively Bargained Voluntary Employee Beneficiary Associations (VEBAs). Contributions to a VEBA are tax deductible and resultant earnings are tax free. This funding option is available only for bargaining unit employees and requires good faith bargaining between the employee (or his/her representative) and the employer with respect to the benefits provided by the plan. Up to this point in time, the bargained VEBA is the only prefunding vehicle GTE has employed because of its tax advantages.

If required by the Commission, GTE will fund the portion of the accrual for which exogenous treatment is granted. However, it is important to understand that this is not in the best interests of the ratepayer. The rate base treatment prescribed in Responsible Accounting Officer ("RAO") Letter 20 calls for the

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<sup>32</sup> AT&T at 15.

interstate portion of unfunded accrued postretirement benefits recorded in Account 4310 to be deducted from the rate base and the interstate portion of any prepaid postretirement benefits recorded in Account 1410 to be added to the rate base. This rate base treatment actually results in an increase in sharing if sharing is present. Also the return earned on funds reinvested in the Company is typically greater than those placed in other investment vehicles.

In light of the fact that RAO Letter 20 accounting procedures will be implemented upon adoption of SFAS-106 to track the liability, and that such a procedure is favorable to the ratepayer, GTE recommends AT&T's request for full funding be rejected.

An additional concern which GTE has with regard to funding is that the Company will most likely not be required in all intrastate jurisdictions to fund its OPEBs accrual. If required to fund by the FCC, GTE will be required to determine what portion of each employee's OPEBs contribution should be attributed to interstate operations. Funding based on the interstate activity of an individual would be difficult and costly to administer.

G. ACCRUAL ACCOUNTING DOES REFLECT A REAL COST AND REQUIRES EXOGENOUS TREATMENT

Ad Hoc and MCI commented that OPEBs expense treatment is only an accounting change, does not result in increased costs, does not involve a cash outlay and is not an economic expense.

"The carriers would treat the FAS 106 balance sheet adjustment as if it were an actual cost outlay. It is not."<sup>33</sup> "Simply put, FAS 106 is only an accounting change."<sup>34</sup> "In short, an economic liability that LECs had when price caps was started will now be recognized but because there is no increase in actual cost to the LECs, there is nothing to be passed on to the ratepayer."<sup>35</sup> "But if the money is never actually spent by the company, then it is certainly true that it is not an economic expense."<sup>36</sup> "Why would the FCC allow the LECs to pass on a non-cash cost increase that other firms who face the real marketplace cannot pass on? ... Thus there is an uphill battle for the LECs and a heavy burden of proof assumed by the LECs to convince the FCC and ratepayer that a purely accounting cost change should result in increased prices for telecommunications services."<sup>37</sup> "It does not, by itself, alter the underlying costs of providing telephone service, but rather formally recognizes costs already being incurred by the LECs."<sup>38</sup>

In its historic rewrite of the Uniform System of Accounts, the FCC adopted Generally Accepted Accounting Principles ("GAAP") and its concepts. The adoption confirmed the acceptance of GAAP

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<sup>33</sup> Ad Hoc Appendix I at 2.

<sup>34</sup> Ad Hoc Appendix I at 11.

<sup>35</sup> Ad Hoc Appendix I at 12.

<sup>36</sup> Ad Hoc Appendix I at 13.

<sup>37</sup> Id.

<sup>38</sup> MCI at 8.

and its concepts -- a main pillar of which is accrual accounting. The Commission has historically utilized accrual accounting methods for ratemaking, and adoption of this SFAS is consistent with that position. Just as accrual methodology is the very backbone of accounting, so has it been historically used and relied upon for ratemaking purposes. Treatment of SFAS-106 accruals should be no different.

The SFAS-106 accounting methodology for these benefits requires the change from cash basis to accrual basis which is the preferred treatment of virtually all other business costs. Current accounting requirements, as they relate to OPEBs, and ratemaking policies result in an intergenerational shifting of costs by requiring future generations of ratepayers to pay for the cost of benefits which are earned today while current ratepayers are paying for benefits which relate to service and benefits earned in prior years.

OPEBs costs are a reasonable and necessary cost incurred in the provisioning of telephone service, since they are an integral part of the Company's ability to attract and retain quality employees. The Commission has recognized that as such by authorizing recovery on a pay-go basis in the past. SFAS-106 modifies only the methodology of recognizing these costs by requiring use of accrual accounting. Cash outlays for payment of existing claims will not change but annual expense to be recognized for financial reporting will increase. There is no change in the fact that these costs are still a reasonable and necessary cost incurred in the provisioning of telephone service.

In addition, cash outlays associated with funding will increase as the Company continues to pursue collectively bargained VEBAs.

GTE maintains OPEBs costs are similar to other benefit expenses incurred by the Company and should receive similar ratemaking treatment. Financial rating agencies and Warshawsky in his paper on postretirement health benefit plans appear to share this opinion.

Warshawsky comments on the very real effect OPEBs will have on LEC financial reports, "It is clear that implementation of the proposed accounting standards would have a large negative impact on reported corporate profits...."<sup>39</sup>

Duff & Phelps addresses the need/anticipation of ratemaking treatment in a general industry report:

The full impact of adoption of SFAS 106 upon credit ratings is uncertain until rate treatment is determined by regulators. Regulatory recognition of PBOPs should be comparable to that for pensions and for nuclear decommissioning. The liability has been known, but the magnitude is greater than expected for many companies. Absent a revenue increase or deferral of costs as a regulatory asset under SFAS 71, the PBOPs accruals would lower reported net income but not immediate cash flow. Assuming that a regulatory commission permits recovery or authorizes deferral of the accrued PBOPs expenses, then net income would not be adversely affected. In addition, recovery of the accrued costs would allow utilities to prefund these costs. Without prefunding of PBOPs costs or the establishment of a firm regulatory asset, a major concern becomes the capital ratios to be used to establish rates of allowed

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<sup>39</sup> Mark Warshawsky, Postretirement Health Benefit Plans: Costs and Liabilities for Private Employers, No. 76, Finance and Economics Discussion Series, Division of Research and Statistics, Division of Monetary Affairs, Federal Reserve Board, Washington D.C., June 1989, p. 18.

returns and the ultimate earnings level of the utility.<sup>40</sup>

Later in the paper it is concluded that "credit ratings will be favorably impacted in those situations where companies are granted revenues currently. The credit implication is negative where the reported PBOs liability is greater than had been anticipated, resulting in a very large future obligation. Clearly, any commission reluctance to recognize the full obligation under SFAS 106 would be negative."<sup>41</sup>

Standard and Poor's echoes this position in a Creditweek article entitled "Utilities and FAS 106" which states, "Under a worst case scenario, unresponsive regulatory treatment which leads to a reduction in cash flow may result in immediate, negative ratings actions."<sup>42</sup>

#### H. CALIFORNIA DIVISION OF RATEPAYER ADVOCATES TESTIMONY

Ad Hoc filed testimony of the California Public Utilities Commission ("CPUC") Division of Ratepayer Advocates prepared for the Phase II hearings on SFAS-106 in the state of California. The CPUC's investigation (I. 90-07-037) was opened to gather information and to analyze the ratemaking impacts of SFAS-106. The investigation was bifurcated into two phases. Phase I dealt with funding of the OPEBs liability prior to adoption and Phase

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<sup>40</sup> Duff & Phelps Perspective, SFAS 106 and Its Impact on Utility Credit Quality, Issue No. 2, March 19, 1992, pp. 2-3.

<sup>41</sup> Id. at 3.

<sup>42</sup> Standard & Poor's Creditweek, Utilities and FAS 106, June 15, 1992, p. 3.

II dealt with the adoption of SFAS-106 for accounting purposes and the ratemaking implications. A significant portion of the Division of Ratepayer Advocates' ("DRA") testimony deals with issues the Commission has already decided. Specifically, the FCC has already adopted SFAS-106 for accounting and ratemaking purposes. The critical issue being decided in this docket is whether SFAS-106 costs qualify for exogenous treatment and the reasonableness of the methods employed by LECs in calculating these costs. While the DRA does touch upon some of these issues, as they relate to filings made by Pacific Bell and GTE California, they are not specific to this proceeding. DRA's comments relate to the California New Regulatory Framework and CPUC directives which govern that framework. GTE maintains, any issue raised by DRA, which in general has an application to this proceeding, has been raised in the comments filed by AT&T, MCI, Ad Hoc and ICA. In this rebuttal, GTE has responded to each of the intervenors comments and, in doing so, has responded to any relevant issues raised by DRA.

#### **CONCLUSION**

In its Rebuttal, GTE has addressed the concerns of AT&T, Ad Hoc, ICA and MCI. GTE, once again, concludes the issuance of SFAS-106 constitutes administrative action beyond the control of GTE and that the Godwins study clearly demonstrates that GTE will recover only a small portion of its SFAS-106 costs through the GNP-PI. The Commission should recognize the change in accounting

necessary for implementation of SFAS-106 as an exogenous cost change.

Respectfully submitted,

GTE Service Corporation and  
its affiliated domestic  
telephone operating companies

Richard McKenna, HQE03J36  
Charles J. Somes, HQE03J28  
GTE Service Corporation  
P.O. Box 152092  
Irving, TX 75015-2092  
(214) 718-6999



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Gail L. Polivy  
Daniel L. Bart  
1850 M Street, N.W.  
Suite 1200  
Washington, DC 20036  
(202) 463-5212

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Their Attorneys

## Certificate of Service

I, Jennifer R. McCain, hereby certify that copies of the foregoing "Rebuttal Of GTE" have been mailed by first class United States mail, postage prepaid, on the 31st day of July, 1992 to the parties on the attached list:

  
Jennifer R. McCain

Service List  
92-101  
July 31, 1992

Charles C. Hunter  
Gardner, Carton & Douglas  
1301 K Street, NW  
Suite 900, East Tower  
Washington, DC 20005  
Counsel for Ad Hoc  
Telecommunications Users  
Committee

Francine J. Berry  
American Telephone & Telegraph  
295 North Maple Ave.,  
Rm 3244J1  
Basking Ridge, NJ 07920

Floyd S. Keene  
Ameritech  
2000 W. Ameritech Center Drive  
Room 4H88  
Hoffman Estates, Illinois  
60196-1025

Leslie A. Vial  
Bell Atlantic  
1710 H Street, NW  
Washington, DC 20006

William B. Barfield  
BellSouth Corporation  
Suite 1800  
1155 Peachtree Street, NE  
Atlanta, GA 30367-6000

Brian R. Moir  
Fisher, Wayland, Cooper  
& Leader  
1255 23rd Street, NW  
Suite 800  
Washington, DC 20037-1170  
Counsel for International  
Communications  
Association

Michael F. Hydock  
Senior Staff Member  
MCI Communications Corporation  
1801 Pennsylvania Ave., NW  
Washington, DC 20006

Mary McDermott  
NYNEX  
120 Bloomingdale Rd.  
White Plains, NY 10605

James L. Wurtz  
Pacific Bell and Nevada Bell  
1275 Pennsylvania Ave, NW  
Washington, DC 20004

Josephine S. Truber  
General Counsel  
Rochester Telephone  
Corporation  
180 South Clinton Avenue  
Rochester, NY 14646

Linda D. Hershman  
Vice President -  
External Affairs  
Southern New England  
Telephone Company  
227 Church Street  
New Haven, Connecticut 06506

Durward D. Dupre  
Southwestern Bell Telephone  
Company  
1010 Pine Street, RM 2114  
St Louis, MO 63101

Martin T. McCue  
General Counsel  
United States Telephone  
Association  
900 19th Street, NW, Suite 800  
Washington, DC 20006-2105

Jay C. Keithley  
Vice President  
United Telephone Companies  
1850 M Street, NW  
11th Floor  
Washington, DC 20036

Lawrence E. Sarjeant  
U S West Communications, Inc.  
1020 19th Street, NW  
Suite 700  
Washington, DC 20036

\*Downtown Copy Center  
1919 M Street NW  
Suite 640  
Washington, DC 20036

\*By Hand