A. BellSouth's actuarial assumptions comply with SFAS-106 and reflect actual experience.

Both Ad Hoc and ICA rely on the ETI paper that is highly critical of the manner in which the SFAS-106 accrual is calculated.[46] The ETI paper is rife with inaccuracies and misunderstandings (or misrepresentations) about SFAS-106 and the manner in which it is calculated, particularly with regard to actuarial assumptions, SFAS-106's substantive plan requirement, and the difference between funding requirements and expensing requirements.

ETI asserts that the LECs' SFAS-106 accruals reflect estimates based on actuarial forecasts and techniques that cannot be fully tested.[47] This assertion is false. The actuarial forecasts and techniques used in the calculation of the SFAS-106 expense have been used by the insurance industry since the inception of insurance contracts and have been fully tested by comparing actual experience to the assumptions used. BellSouth's tables and assumptions are derived in the same manner as those used by insurance companies. A comparison between BellSouth's actual experience and the assumptions used are reviewed

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[46]ETI at 2, 8-12.

[47]ETI also asserts that the costs resulting from SFAS-106 adoption are not auditable. ETI at 6. These costs are subject to the same review as all other costs recorded on the financial statements of the LECs. No additional audit requirements for SFAS-106 costs are necessary.

periodically. Updates to assumptions are made when appropriate.

The telecommunications industry has been using these actuarial techniques since January, 1967 when the Accounting Principles Board (APB) required the adoption of the first accrual method for expensing pension costs.[48] Virtually every business in the economy expenses insurance costs, which are based on actuarial assumptions and techniques of the kind employed by the LECs to estimate SFAS-106 costs.[49]

ETI asserts that the actuarial assumptions of the LECs vary so significantly that "they should simply be rejected."[50] ETI's call for such arbitrary and capricious action on the part of the Commission must be rejected. ETI notes differences in the discount rates, return on plan assets, estimated medical care cost trend rate, retirement rate, turnover rate and mortality rate.[51] ETI fails to recognize that the rates and assumptions used by each LEC are based on the experience, demographics and benefit plans of that company. To the extent that there are differences

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[48]APB 8, "Accounting for the Costs of Pension Plans", effective January 1, 1967.

[49]ETI probably expenses insurance costs. Premiums for most insurance contracts are based on actuarial assumptions and forecasting techniques of the type that ETI here characterizes as "untested".

[50]ETI at 9.

[51]ETI at 8. The MCI Opposition expresses similar concerns at 27.

among companies, it is both appropriate and required by SFAS-106 that the actuarial assumptions vary.

The FCC noted the differences among carriers and the effect that those differences can have on relative pension expense levels in its pension investigation. The Memorandum Opinion and Order released October 30, 1987 stated the following:

> A great many factors influence the calculations of pension costs. Workforce demographics, fund performance, interest rates, plan amendments and other factors are mixed with projections and actual experience. . . . These factors differ from carrier to carrier and period to period. For example, an elementary review of the relationship between active and retired employees in management plan data filed with this Commission in 1986 will reveal one significant demographic difference between BellSouth and Southwestern Bell. BellSouth's relationship between active and retired employees is 2.3 to 1 as opposed to a 3 to 1 relationship for Southwestern Bell. . . companies with fewer active employees in relationship to retired employees usually have higher pension costs.[52]

The differences noted above apply equally to SFAS-106 expense levels. For example, SFAS-106 makes the following statement relative to choosing a discount rate: "employers shall look to rates of return on high-quality fixed-income investments currently available whose cash flows match the timing and amount of expected benefit payments."[53] The LECs

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[52]In the Matter of Use of Certain Generally Accepted Accounting Principles in Part 32 of the Commission's Rules, Memorandum Opinion and Order, 2 FCC Rcd 6675 at para. 12 (1987).

[53]SFAS-106 at para. 31.

have different plans, different average remaining lives of active employees and different percentages of retirees to active employees. Therefore, the amount <u>and</u> timing of expected cash flows will vary from company to company. Under these circumstances, the use of the same discount rate by all LECs would undoubtedly mean some LECs would be in violation of the requirements of SFAS-106.

The difference in the medical trend rate should also be understandable. If all LECs were required to use the same medical trend rate, this would imply that the cost of medical care was the same across the nation. This is certainly not the case. To the extent that medical costs vary from one region of the country to another, medical trend rates will also vary.

ETI is also confused as to the purpose of some of the actuarial assumptions used by the LECs. ETI asserts:

> There may be, of course, technical questions such as how SFAS-106 treats an employee who leaves a company before retirement although post retirement medical benefits had somehow been accrued and expensed on the balance sheet.[54]

It is obvious from this statement that ETI does not understand the basic requirements of calculating the SFAS-106 expense. SFAS-106 makes the following statement:

> [M]easurement of the expected postretirement benefit obligation is based on the expected amount and timing of future benefits . . . .[55]

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[54]ETI at 12.

[55]SFAS-106 at para. 20.

The turnover rate (one of the assumptions questioned by ETI) effectively removes the benefit expense for those employees who are expected to leave before retirement from the SFAS-106 expense calculation. This assumption is determined by observing the separation pattern of a company's workforce and can be predicted accurately. Therefore, although an individual employee may leave the company before retirement and thus not receive OPEBs, the accrual accurately reflects the aggregate experience of the entire class of employees who receive OPEBS.

Other assumptions, such as mortality and retirement rates, are also derived based on historical data about employees and retirees that companies have tracked for many years. Consequently, these rates can also be predicted accurately.[56]

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[56]MCI's assertions that the actuarial assumptions have been chosen arbitrarily, and that the "LECs rely on outdated information" are false. (MCI Opposition at 28) BellSouth's assumptions are based on BellSouth's actual experience. MCI's assertion relative to the effects of downsizing on the turnover rate (MCI Opposition at 28, fn. 35) is also incorrect. BellSouth's downsizings have been through early retirement programs rather than layoffs. Early retirement programs do not affect turnover. Rather the immediate impact is to reduce the future rate of retirements since retirement eligible employees who do not take the early retirement offer evidently plan to delay retirement for several years. BellSouth considered the need for an adjustment to its turnover rate in light of its early retirement programs, but no such adjustment was required. BellSouth's retirement rate was adjusted to reflect the effects of the early retirement programs.

Along with misunderstandings about actuarial assumptions, ETI also is confused about the provisions of SFAS-106 regarding the use of substantive plan. ETI implies that following the rules of SFAS-106 results in a less precise postretirement accrual amount than will result if the rules of Section 419 or 501(c)(4) of the Internal Revenue Code are followed. This implication rests on the fallacy that SFAS-106 requires use of the substantive plan while the IRS code requires the use of the written plan.[57] As evidence of the more liberal policy allowed by the FASB, ETI compares the LECs estimated fund contributions to the estimated SFAS-106 costs and notes that the SFAS-106 costs are substantially higher. This statement and the comparisons made are flawed on several counts.

ETI has incorrectly interpreted SFAS 106 as requiring that postretirement costs be calculated based on the "substantive" plan rather than the formal written plan. In reality, SFAS 106 states that the extant written plan provides the best evidence of the terms of exchange between the employer and employees. The Statement notes, however, that the plan as understood by the parties to the exchange (the substantive plan) might differ from the extant written plan. In this instance, SFAS 106 directs that the substantive plan shall be the basis for the accounting.[58]

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[57]ETI at 8.

[58]SFAS 106 at para. 23.

Use of the substantive plan requires that certain conditions be met.[59] These conditions are more stringent for plans subject to collective bargaining. SFAS-106 permits the use of the substantive plan because the FASB realizes that an enforceable promise (consequently, a liability) may exist even if a formal written plan is not in evidence. Whether or not an enterprise should account for SFAS-106 costs under the substantive plan or the extant written plan must be based on that enterprise's particular circumstances.

ETI apparently does not realize that SFAS-106 and the IRS tax deductible funding limits are calculated using different sets of rules.[60] BellSouth uses the aggregate cost method for calculating tax deductible funding limits which is different from the projected unit credit method required by SFAS 106. Because the rules used to calculate SFAS-106 expenses differ from those used to calculate funding limits, the amounts will differ even if the written

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[59] Id. at paras. 23 and 24.

[60] ETI also appears to be confused about the difference between funding and expensing. ETI makes the following statement: "Unlike pension plans, PBOPs are not governed by the Employment Retirement Income Security Act (ERISA) and are not subject to any uniform governmental regulation." ETI at 9. The pension expense that companies book is not subject to ERISA requirements, but rather is calculated in accordance with the requirements of SFAS-87, "Employers' Accounting For Pensions". These rules for expensing are much like the rules for expensing postretirement benefits. ETI's comparison between ERISA and FASB requirements is simply another of the unrelated diversions that abound in its paper.

plan is used in both instances.[61] Because of these differences, ETI's comparison of SFAS-106 costs to fund contributions yields results that have no meaning. In addition, the comparison should be disregarded because all companies cited have not funded on the same basis. For example, all companies have not funded for all employees and retirees[62] and all companies have not funded the maximum amount allowed under the IRS Code.[63] ETI's flawed comparisons are patently meaningless.

B. AT&T's criticisms addressing the variation in LEC cost per employee are invalid.

AT&T's critical analyses of LEC plan assumptions have no merit. One analysis[64] purports to demonstrate a tremendous variation in the range of cost per employee among the LECs. To derive the cost per employee used in

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[61]ETI's comparison of VEBA funding with SFAS-106 expense on page 8, footnote 13 is meaningless. BellSouth uses the written plan to calculate both numbers attributed to it in the ETI footnote. The difference in the calculated amounts in no way reflects any evidence that the attribution method used in SFAS-106 is "less precise" than the attribution method used by the IRS.

[62]See, BellSouth Direct Case at 13. In addition the $191 million listed as BellSouth's fund contribution is in reality a combination of fund contributions and pay-as-you-go amounts. See, BellSouth Direct Case at Appendix 2. ETI Table A includes incorrect pay-as-you-go amounts for BellSouth. Compare BellSouth Direct Case at 12, where the pay-as-you-go amounts are reported as $138.3 million for 1991 and $149.5 million for 1992 with ETI, Table A, which shows $38.8 million and $46.5 million respectively. No valid conclusions can be drawn from Table A.

[63]See, U S West Direct Case at 11.

[64]AT&T Opposition at 22.

performing this analysis, AT&T divides the LECs total company OPEB costs as filed in their direct cases by the total number of active and retired employees included in their 1991 FCC Form M reports. AT&T asserts that the variation in cost per employee is indicative of the variety of actuarial and macroeconomic assumptions used by the LECs.[65]

AT&T admits that some of the variation is due to the effects of the accumulated balances in the LECs' VEBA trusts, which would reduce the total OPEB costs (and thus the cost per employee) of the LECs that pre-funded.[66] However, AT&T concludes that the level of funding for the LECs[67] is limited and will not affect the OPEB cost per employee that AT&T calculated.

AT&T's analysis is erroneous. First, the LECs established VEBA trusts at different times.[68] In addition, the LECs have different prefunding policies. For example, BellSouth prefunds for only a portion of its employee/retiree population, while Ameritech prefunds for all employees and retirees. These differences will cause

[65]AT&T Opposition, Appendix E.

[66]AT&T Opposition, Appendix E at 1.

[67]BellSouth being the exception.

[68]BellSouth established its VEBA trust in 1985. Ameritech established its VEBA trust in 1988 (Direct Case at 17). Pacific Bell (Direct Case at 11) and US West (Direct Case at 11) established theirs in 1989.

varying impacts on the LECs' total OPEB costs. They cannot simply be disregarded as AT&T suggests.

AT&T includes another analysis[69] that purports to demonstrate the "generosity" of the LECs' plan assumptions. This analysis compares the LECs' pay-as-you-go amounts to their SFAS-106 liability. AT&T implies that the actuarial assumptions of a LEC with a high percentage of pay-as-you-go to SFAS-106 expense is less "generous" than that of a LEC with a low percentage. The percentages range from a low of 19% (Rochester) to a high of 71% (BellSouth). Again, AT&T ignores the effects that prefunding has on a LECs' total OPEB cost. Prefunding would reduce the total OPEB cost and therefore increase the percentage. Because AT&T makes no effort to quantify the impact that prefunding has on its analyses, the analyses are fundamentally flawed and do not support the conclusions drawn from them by AT&T.

AT&T ignores the effect that a LEC's percentage of retirees to actives will have on the percentage of pay-as-you-go to SFAS-106 expense. Relatively speaking, the higher the percentage of retirees to actives, the higher will be the pay-as-you-go expense. This would also affect the pay-as-you-go/SFAS-106 percentage calculated by AT&T.

The Commission should disregard AT&T's faulty and self-serving analyses. Both SFAS-106 and pay-as-you-go amounts have embedded in them elements that affect the levels of the

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[69] AT&T Opposition, Appendix G.

respective expenses that are unrelated to the actuarial assumptions used or the "generosity" of the plan. Without removing these elements, the conclusions reached by AT&T in their analyses are meaningless.

AT&T's comments also incorrectly describe the BellSouth plan. AT&T asserts that BellSouth's caps are effective in the current period.[70] In fact, as BellSouth shows in its Direct Case, the premium payments will be deducted from pension payments beginning January 1, 1993.[71]

Finally, AT&T argues that the Commission should prescribe uniform actuarial assumptions to be used by all LECs for cost recovery purposes.[72] This action would ignore the actual postretirement expense that each LEC incurs. AT&T also implies incorrectly that a LEC that hasn't capped their benefits is not attempting to control their OPEB costs. As AT&T is certainly aware, each company must negotiate the benefit plan that will enable it to compete

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[70] AT&T Opposition at 20.

[71] BellSouth Direct Case at 19.

[72] AT&T recommends that the Commission "pick and choose" among the various LEC Direct Cases for the set of actuarial assumptions that would produce the lowest number for the SFAS-106 accrual and then mandate that hybrid set of assumptions for all the LECs for purposes of calculating the exogenous cost accrual. AT&T Opposition at 25. AT&T characterizes this approach as resulting in "reasonable and conservative estimates of the OPEB liability for pricing purposes." Id. There is nothing "reasonable" about such a biased proposal. One assumes that the authors of AT&T's opposition did not seek an opinion from AT&T's actuaries before advancing such an unprofessional proposal. Adoption of AT&T's proposal would be patently arbitrary and capricious.

for labor resources in the labor market in which that company operates. Just as salary and wage requirements are different in different areas of the country, so will benefit requirements be different. To the extent that benefit requirements are different, each LEC must use assumptions that will fulfill one of the underlying purposes of SFAS-106, i.e., to correctly value the agreement that the individual employer has made with its employees. Postretirement expenses are incurred prudently and in good faith in conjunction with providing services to ratepayers. AT&T has made no showing that would justify a Commission disallowance of a portion of those prudently incurred costs for ratemaking purposes. Any such disallowance would be arbitrary and capricious.

VI. Conclusion.

The Commission adopted a price cap plan for the LECs that contains, as an integral and essential part of that plan, recognition of exogenous costs. The LECs have accepted prior exogenous cost adjustments that have resulted in significant decreases in their price cap indices. Now, when a significant exogenous cost adjustment will go in the other direction, LEC opponents have resorted to desperate measures to try to avoid the proper working of price cap regulation. Rather than address the merits of the Direct Cases, opponents have distorted the Commission's criteria for exogenous cost treatment, suggested inaccurate "benchmarking" among the LECs, misrepresented or misunderstood the requirements of SFAS-106, and misrepresented the nature of the costs that are caused by SFAS-106. The Commission should not be distracted by these tactics.

The LECs have made a showing that complies in all respects with the requirements of the price cap plan to secure exogenous cost treatment of their SFAS-106 costs. The Commission should grant such exogenous treatment.

Respectfully submitted,

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July 31, 1992

EXHIBIT 1

Assume an expected medical benefit stream, **M**, over **n** years that is anticipated to grow at a medical inflation rate $\dot{P}_m$. The present value of such a stream is

$$PV = \sum_n \frac{M(1+\dot{P}_m)^n}{(1+d)^n},$$

where **d** is the discount rate, normally a long term rate which includes anticipated inflation, as measured by the GNPPI, or **g**. Thus:

$$d \approx g + r,$$

where r = real rate. $\dot{P}_m$ is presumably embedded in, and tracks the GNPPI:

$$\dot{P}_m = g + e,$$

where e > o both historically and for the foreseeable future, and represents medical cost growth exceeding the GNPPI. Thus, substituting,

$$PV = \sum_n \frac{M(1+g+e)^n}{(1+g+r)^n}$$

Hence, GNPPI (g) is in both the numerator and denominator and effectively cancels (There is a small residual, but it is inconsequential at low inflation rates.) Hence AT&T's suggestion that **g** be subtracted from the numerator is incorrect.

CERTIFICATE OF SERVICE

I hereby certify that I have this 31st day of July, 1992 serviced all parties to this action with a copy of the foregoing REPLY TO OPPOSITIONS TO DIRECT CASE by placing a true and correct copy of same in the United States mail, postage prepaid, addressed to:

Gaye Fidelibus

Gaye Fidelibus

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