

The TBO represents expenses for retiree nonpension benefits and is not affected by any future wage change. Thus, based on this fact alone, there is no relationship between the TBO and future wage changes.

Fourth, MCI implies by its allegation that LECs are requesting exogenous treatment for the level of OPEBs. The price cap LECs, however, have requested exogenous treatment for only the incremental costs imposed by SFAS-106 adoption.

4. An Arbitrary Limitation On The SFAS-106 Accrual Amount To Be Given Exogenous Treatment Is Inappropriate.

AT&T requests that, where LEC ability to control OPEB costs exists, limitations should be placed on the SFAS-106 accrual amounts given exogenous treatment so as to eliminate a windfall for those LECs that have not implemented cost control methods.<sup>41</sup>

SWBT's SFAS-106 valuation already reflects the effects of past and future cost control methods.<sup>42</sup> SWBT currently uses a defined dollar cap on retiree health benefits. SWBT's actuarial valuation for its SFAS-106 expense estimates included this cap in the basic assumptions. This cap has acted to limit SFAS-106 expenses compared to what they would be absent the cap. While health care costs have to be intelligently managed, SWBT does not look to exogenous treatment for OPEBs under SFAS-106 as a replacement for these containment efforts. Imposing arbitrary

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<sup>41</sup> AT&T at pp. 20-21.

<sup>42</sup> See, SWBT Direct Case at pp. 12-13, 29, Exhibit 2, and Exhibit 5, p. 5.

limits or benefits caps on LECS cannot and should not substitute for individual company management decision-making.

Clearly, AT&T is not recommending that LECS utilize uniform actuarial assumptions in the quantification of the OPEB liability for external financial reporting purposes. Such a forced uniformity would conflict with the FASB requirements that each company's valuation be reflective of each company's unique circumstances.

An example of the need for some company diversity is the fact that the three largest interexchange carriers used three different discount rates in their valuations of pension liabilities contained in their 1991 Annual Reports.

E. LECs Need Not Further Demonstrate The Disproportionality of SFAS-106 Expenses.

Ad Hoc claims that the denial of a Bell Atlantic request for exogenous cost recovery of certain Pennsylvania tax law changes govern the instant proceeding.<sup>43</sup> The initial order denying Bell Atlantic's request for exogenous treatment stated:

The limited list of exogenous cost changes codified in the Commission's Rules at Section 61.45(d) allow the price cap to fluctuate in response to certain specific cost changes that are (1) imposed by government action; and (2) which are unique to or disproportionately affect common carriers. The Commission determined that these cost changes are not likely to be reflected in the inflation measure.<sup>44</sup>

Consequently, Ad Hoc suggests that price cap LECS must demonstrate

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<sup>43</sup> Ad Hoc at pp. 8-9.

<sup>44</sup> Bell Atlantic Telephone Companies, Tariff F.C.C. No. 1, Transmittal No. 473, 7 FCC Rcd. 1486 (1992) at para. 9.

that the SFAS-106 cost change is unique to or disproportionately affects LECs.<sup>45</sup>

For two key reasons, price cap LECs are disproportionately affected by SFAS-106. First, as the record already demonstrates, the incremental costs imposed by SFAS-106 costs are higher for price cap LECs than for the rest of the U.S. economy. In this proceeding, Godwins has presented a detailed actuarial analysis that compares the effect of SFAS-106 on price cap LECs with the effect on other companies in the U.S. economy. The Godwins analysis concludes that SFAS-106 has a significantly disproportionate effect on the price cap LECs compared to other companies.

Second, LECs under the regulatory oversight of the Commission have been prohibited from rate recovery of full adoption of accrual accounting for OPEBs.<sup>46</sup> Companies not subject to regulation of prices have been free to adjust prices to reflect the economic cost of OPEBs. SWBT and other LECs have been explicitly prohibited from doing so.

Thus, exogenous treatment should not be denied because of rejection of exogenous cost treatment of the Pennsylvania tax law changes. This SFAS-106 change disproportionately affects LECs.

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<sup>45</sup> Ad Hoc at pp. 7-8.

<sup>46</sup> See, SWBT Direct Case at pp. 13-14.

F. Denial Of Exogenous Cost Recovery Of SFAS-106 Costs Is Not Necessary To Achieve An Appropriate Balance Between Risk And Reward For Price Cap LECs.

Ad Hoc claims that denial of the request for exogenous cost treatment is necessary "to ensure that risks borne by LECs are adequate to justify the higher financial rewards of incentive regulation."<sup>47</sup> Nevertheless, even without the significant financial risk that would be caused by any failure to allow rate recovery of the increased SFAS-106 costs, there are significant risks already associated with the Commission's price cap plan for LECs.<sup>48</sup> The very short list of additional LECs that volunteered to adopt price cap regulation is evidence of this situation. None of the following arguments by Ad Hoc and others provide justification for denial of exogenous treatment in order to increase risk.

1. Exogenous Cost Recovery Of SFAS-106 Costs Is Not An Opportunity For Increased Profits.

AT&T contends that exogenous cost recovery of SFAS-106 costs represents an opportunity for increased profits without increased productivity or risk, resulting in an unwarranted rate of return increase.<sup>49</sup> Ad Hoc contends that exogenous cost recovery is an opportunity for windfall profits.<sup>50</sup> Both AT&T and Ad Hoc are

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<sup>47</sup> Ad Hoc at p. 17.

<sup>48</sup> Examples of these risks include: the productivity offset and common line demand adjustment; limited pricing flexibility; endogeneity of depreciation; expanded interconnection; and the rapid pace of technology.

<sup>49</sup> AT&T at p. 24.

<sup>50</sup> Ad Hoc at p. 17.

incorrect.

Absent exogenous cost recovery, price cap LECs will experience a large increase in costs without an increase in revenue, resulting in a significant reduction in net income. Full rate recovery for increased SFAS-106 costs would leave LEC net income unchanged.

SWBT and the other price cap LECs have requested that a portion of the increased SFAS-106 costs be treated as exogenous. Exogenous treatment does not presume that productivity is not present. In fact, for SWBT to offset the future expense increases associated with pay-as-you-go OPEB costs<sup>51</sup> (a major portion of total OPEB costs for which price cap LECs have not requested exogenous cost recovery), significant productivity on SWBT's part will be required. Thus, any contention that the need for LEC productivity will be lessened with exogenous treatment of SFAS-106 costs, is fundamentally flawed.

2. It Is Irrelevant To Determine Whether The Obligations Estimated Under SFAS-106 Are Not Legally Binding.

Ad Hoc claims that OPEBs can be modified and that LEC employees have no statutory right to OPEBs.<sup>52</sup> Ad Hoc argues that LECs could therefore use exogenous treatment to inflate PCIs and never provide the OPEBs.

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<sup>51</sup> For the eleven price cap LECs as a whole, pay-as-you-go OPEB costs in 1991 were approximately equal to the incremental effect of

Assuming, arguendo, that Ad Hoc's legal opinion regarding such benefit plan agreements is correct, SFAS-106 requires major changes in plan provisions and/or actuarial assumptions to be taken into account when computing subsequent years' net periodic OPEB expense. Changes like those referenced by Ad Hoc are required to be quantified and amortized over the remaining service lives of plan participants by SFAS-106.

It should also be noted that SWBT's valuation assumed a defined dollar benefit cap which served to reduce the SFAS-106 benefit expense. Other postretirement benefits related to nonmanagement employees are established as the result of the collective bargaining process.

3. An Exogenous Cost Showing Need Not Satisfy A "Confiscation" Standard.

ETI quotes from the SWBT Midcourse Order<sup>53</sup> that an "extraordinary exogenous cost showing must be grounded in a demonstration that, without the adjustment, rates under price cap regulation would be confiscatory."<sup>54</sup> Nevertheless, there is no general "confiscation" requirement for an exogenous cost showing.

First, ETI, as well as Ad Hoc and AT&T, fail to note that SWBT has petitioned the District of Columbia Circuit of the United

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<sup>53</sup> Southwestern Bell Telephone Company Application for Review, Transmittal No. 2051, 7 FCC Rcd. 2906 (1992) (SWBT Midcourse Order); Petition for Review pending, SWBT v. FCC, Case No. 92-1220, D.C. Circuit.

<sup>54</sup> ETI at p. 7, quoting SWBT Midcourse Order at para. 32. See also, Ad Hoc at pp. 10-11 and AT&T at pp. 23-24.

States Court of Appeals for review of the SWBT Midcourse Order.<sup>55</sup> The SWBT Midcourse Order is invalid insofar as it incorrectly applied the LEC Price Cap Order to SWBT's Transmittal No. 2051.<sup>56</sup> SWBT had submitted its Transmittal No. 2051 Midcourse Filing under the Commission's rate of return methodology. Price cap regulation, with its mechanism for exogenous cost treatment, was not correctly applied to SWBT's Midcourse Filing. Thus, the quoted discussion of exogenous cost standards, in the context of SWBT's Midcourse Filing, was dicta. The SWBT Midcourse Order did not, and could not, change the standard for exogenous cost treatment.

Second, both ETI and the SWBT Midcourse Order confuse the standards for exogenous cost treatment and above-cap rates. The LEC Price Cap Order discusses a confiscation-type standard in conjunction with its description of the necessary showing for an above-cap filing.<sup>57</sup> The LEC Price Cap Order, however, contains no similar requirement for the exogenous cost standard. The language quoted by ETI (paragraphs 31 and 32 of the SWBT Midcourse Order), cites to the LEC Price Cap Order at paragraph 190. Paragraph 190 reads as follows:

Moreover, as we noted when we denied AT&T's request, if we were to allow exogenous treatment of extraordinary costs, we would be setting the stage for an endless succession of arguments focused on whether a particular

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<sup>55</sup> SWBT filed its Petition for Review on May 18, 1992. AT&T, MCI and Pacific Bell and Nevada Bell have filed Motions to Intervene. See, Order, filed June 19, 1992 granting Motions to Intervene.

<sup>56</sup> See, Commissioner Barrett's Dissent in Part to the SWBT Midcourse Order.

<sup>57</sup> LEC Price Cap Order at para. 304.

cost qualifies as "extraordinary." Nevertheless, consistent with the Constitutional ban on confiscatory rates, we leave open the possibility that, in a truly extraordinary situation, we would approve above-cap rates, even perhaps without suspension and investigation. (footnotes and citations omitted)

Clearly, this paragraph references the confiscatory-type standard that is associated with above-cap filings but says nothing about the standard for exogenous costs. Thus, neither the SWBT Midcourse Order nor the cited language in the LEC Price Cap Order support the proposition that an exogenous cost showing is required to meet a confiscation standard.

G. Exogenous Cost Treatment Does Not Interfere With Orderly Administration Of The Price Cap System.

1. Ad Hoc Essentially Argues That the SFAS-106 Issues Need Not Be Addressed Because They Are Difficult.

Ad Hoc contends that to correctly rule on the appropriateness of exogenous cost treatment for SFAS-106, the "FCC would have to resolve disputes regarding actuarial and demographic assumptions," involving the Commission in the type of costing disputes that price cap regulation was supposed to avoid.<sup>58</sup> Ad Hoc seems to claim that the Commission should avoid all tough questions under price cap regulation.

Ad Hoc's recommendation would also seem to imply a recommendation to our federal legislators that, if issues regarding taxation and the level of government expenditures are difficult or require special insight, then they should not be addressed and the consequences of the current federal budget problems should fall on

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<sup>58</sup> Ad Hoc at p. 16.

future generations. There is no doubt that the actuarial and demographic assumptions present challenges to understanding the SFAS-106 issues. The Commission should not conclude, however, that today's customers should not be expected to make a reasonable contribution toward the true costs of benefits earned today, or to require that the current costs of OPEBs be borne by future interstate access customers.

2. The Intent Of The Commission's Price Cap Plan Does Not Conflict With Exogenous Treatment of SFAS-106 Expenses.

Ad Hoc also argues that granting exogenous cost treatment for SFAS-106 costs would disrupt the orderly operation of the Commission's price cap mechanism.<sup>59</sup> ETI states that granting exogenous cost treatment would "violate any rationale for continuing the price caps experiment."<sup>60</sup>

On the contrary, the price cap mechanism is designed with a provision for exogenous cost adjustments so that it would be orderly. The exogenous cost adjustment provisions ensure benefits to customers when Commission-mandated cost changes result in reductions in price cap indexes. The Commission has concluded that:

In fairness to both carriers and ratepayers, however, the basic measure of cost change can be further adjusted upward or downward to account for certain specified cost changes unique

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<sup>59</sup> Ad Hoc, at p. 16.

<sup>60</sup> ETI at pp. 1-2.

to the carrier. These are exogenous costs.<sup>61</sup>

Contrary to the claim by ETI, exogenous cost treatment would not turn price cap regulation into cost-plus regulation. Price cap LECs would be allowed to increase price caps to reflect the fact that the initial price cap rates did not include adequate amounts to reflect the true economic costs of OPEBs.

It is a pure accident of timing that accrual accounting for OPEBs was mandated after price cap regulation was mandatory for SWBT. The OPEB deliberation lasted about 12 years, ending in December of 1990, while the LEC price cap deliberation lasted 4 years, ending in September of 1990. Had the FASB ruling taken one less year, or the LEC Price Cap Order been released only several months later, the timing of the two mandated changes would have been reversed and this proceeding would not have occurred. Prior to the advent of price cap regulation, dollar-for-dollar rate recovery was presumed once a cost had been accepted as a legitimate regulated cost of service.<sup>62</sup> Thus, the basic argument returns to

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<sup>61</sup> Bell Atlantic Telephone Companies, Tariff F.C.C. No. 1, Transmittal No. 473, Memorandum Opinion and Order, (released February 10, 1992) (DA 92-195) at para. 9.

<sup>62</sup> Rate of return carriers are presently being allowed rate recovery of the incremental costs of SFAS-106. MCI challenged recent filings by Centel, Cincinnati Bell and NECA that proposed to raise rates to cover costs associated with a change in the accounting treatment for OPEB. MCI specifically claimed that these carriers had already been compensated for these costs in their current rate of return. The Bureau determined that the OPEB expenses were proper and did not subject them to investigation. 1992 Annual Access Tariff Filings, National Exchange Carrier Association, Universal Service Fund and Lifeline Assistance Rates, CC Docket No. 92-141, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation (DA 92-841) (released June 22, 1992) at para. 70-71.

an examination of the appropriate amount of rate recovery that will be allowed for price cap LECs.

Under price cap regulation, the appropriate standard for exogenous treatment is not based solely on whether the change affects the orderly operation of the mechanism. SWBT has never contended that the SFAS-106 issues were not complex. The elimination of complexity is not "the entire context of the Commission's price cap plan for LECs."<sup>63</sup> ETI appears to equate complexity and lack of orderly operation. Recall that earlier in the price cap docket, the debate over the appropriate productivity offset was extremely complex, requiring a significant amount of detailed analysis by the Commission, the LECs, and other interested parties. Many aspects of the current price cap plan remain complex but it is important to determine if the regulated company has a legitimate cost of service that should be included in prices of regulated services. While significant complexity exists in this docket, it cannot serve as a rationale for not addressing the issues, as ETI unfairly suggests.

H. LEC Cost Estimates Of SFAS-106 Expense Are Reasonable.

Ad Hoc alleges that the LEC cost estimates are too unreasonable and unverifiable to form the basis for an exogenous cost adjustment.<sup>64</sup> On the contrary, Ad Hoc's arguments in this regard, including the ETI claims, do not provide any reason to deny

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<sup>63</sup> ETI at p. 1.

<sup>64</sup> See, Ad Hoc, at pp. 12-13.

exogenous cost treatment, as shown below.

1. LEC Cost Estimates Are Auditable.

ETI claims that the LEC cost estimates are built on assumptions impossible for the Commission to accurately audit.<sup>65</sup> Nevertheless, SFAS-106 provides explicit guidance on how to establish actuarial assumptions for purposes of computing SFAS-106 expense. SWBT has fully complied with this standard in valuing SFAS-106.

SWBT has had independent external accounting/consulting firms specializing in employee benefit obligation valuations review its basic assumptions for reasonableness. For example, the independent public accounting and consulting firm of Ernst & Young has substantially completed a comprehensive review of SWBT's OPEB valuation. SWBT has been informed that nothing reviewed so far would suggest that the OPEB valuation is not materially correct. SWBT expects to receive a report at the conclusion of the Ernst & Young review, which outlines their findings in more detail. SWBT is willing to forward a copy of this report to the Commission when available.

Numerous surveys have compared SFAS-106 assumptions among a variety of companies, both within, and outside of, the telecommunications industry. In light of these surveys, SWBT's

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<sup>65</sup> ETI, p. 1. Compare this statement with ETI's next sentence on p. 1 which alleges "inconsistencies." If such "inconsistencies" can be found, the LEC cost estimates are at least subject to a basic level of audit, and thus auditing is not "impossible" as ETI claims.

assumptions and estimates are within the range of reasonableness. SWBT's cost estimates are not unauditable and are certainly not unreliable to the degree implied by ETI.

2. The SFAS-106 Accrual Process Is Not Too Liberal.

Ad Hoc alleges that the accrual process involves unverifiable actuarial and demographic assumptions that can be manipulated<sup>66</sup>. However, as shown above, the assumptions and estimates can be verified, and Ad Hoc is merely trying to reargue whether SFAS-106 is a reasonable accounting approach.

The nature of accruing for postretirement benefits (like pensions) which are to be paid far in the future requires the use of explicit assumptions to determine the best estimate of future costs. All parties acknowledge that accruing costs based upon estimates involves uncertainty, but the FASB and the Commission have concluded that this method is superior to simply ignoring the obligation and recording expenses as benefits are paid. Thus, Ad Hoc's arguments really are an attempt to reargue the Commission's decision to adopt SFAS-106 accounting for regulatory accounting purposes.

Contrary to Ad Hoc's accusations, the data used in constructing SWBT's valuation is verifiable and has not been manipulated. SWBT is required to disclose the major assumptions in its external financial reporting and these disclosures will be subject to external audit by independent accountants. To allege

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<sup>66</sup> Ad Hoc at p. 13.

that SWBT could manipulate these assumptions completely ignores existing safeguards in the audit process, as well as SWBT's obligations to the investment community.

The differences in the companies' accruals noted by Ad Hoc merely point out that companies have unique circumstances and historical experience surrounding the provisioning of postretirement benefits. As concluded by the FASB, no single set of assumptions could be considered correct for all companies uniformly. Moreover, SWBT's SFAS-106 valuation is reasonably stated due its containment of medical care cost through a defined dollar benefit cap.

3. ETI Unreasonably Creates New Standards For Exogenous Cost Treatment.

ETI claims that the scope of the inquiry must go far beyond the issue of whether a "cost" change is reflected in GNP-PI. ETI argues that exogenous costs must be so clearly identified that they do not pose new cost allocation or assignment problems as difficult as any raised by traditional rate of return regulation.<sup>67</sup>

ETI seems to imply that granting exogenous treatment of SFAS-106 would require the Commission to undertake an ongoing review of OPEB expenses similar to the review of total expenses for Tier 1 LECs under rate of return regulation.

ETI's conclusion is a distortion of the facts. Current price cap rules recognize the need for one-time adjustments to price cap indexes through the exogenous cost mechanism. Having

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<sup>67</sup> ETI at pp. 4-7.

permitted an exogenous adjustment, the Commission is under no obligation to revert to rate of return regulation for any or all of the LEC expenses included in the regulated cost of service. In fact, any Commission attempt to subsequently impose the cost allocation and assignment principles of rate of return regulation would be counterproductive, and would eliminate incentives for efficiency.

4. ETI Arguments For IRS or ERISA-type Regulation Of OPEBs Are Irrelevant.

ETI asserts that there is no check on LEC estimates for SFAS-106, unlike pensions, which are governed by ERISA and IRS regulations.<sup>68</sup> ETI suggests that this alleged lack of control is reason to deny exogenous treatment.

ETI implies that ERISA/IRS requirements on pension funding somehow validates pension expense, and consequently, if SFAS-106 is not governed by ERISA, SFAS-106 costs go unchecked. ERISA/IRS funding requirements, however, such as those required for pensions, are not the basis for quantifying pension expense.<sup>69</sup> Pension expense is computed under SFAS-87 and the Commission has adopted SFAS-87 into Part 32 of the Commission's rules. The calculation of OPEB expense under SFAS-106 is similar in many respects to the calculation of pension expense under SFAS-87. If SFAS-106 and SFAS-87 both use the same methodology for expense, one cannot be rejected in favor of the other. Both SFAS-87 and SFAS-

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<sup>68</sup> ETI at pp. 2, 9.

<sup>69</sup> See SFAS-106 at para. 150.

106 conclude that funding is a financing decision not determinative of accounting treatment and the assignment of costs. There is no reason to conclude that ERISA-type funding activity should be extended to OPEBs.

ETI claims that LEC estimates of OPEB expenses are unlike pensions as OPEB estimates are no more than unenforceable guesses and do not provide sufficient basis for exogenous cost adjustment.<sup>70</sup> SFAS-106 estimates are reasonable because they reflect the best estimates and judgment of the company in compliance with FASB rules and are based on well-accepted actuarial principles. SWBT's SFAS-106 expense estimates, like pension estimates, must be reviewed and approved by independent auditors prior to issuing external financial reports to the SEC and shareholders. These same techniques have been applied in accounting for pensions without material complaint from the investment community, external users of financial statements, or the Commission.

I. SFAS-106 Costs Are Not Discounted To Some Degree In The Existing Nationwide Average ROR Prescribed For All Carriers.

Ad Hoc and MCI argue that the current nationwide average rate of return prescribed for all carriers incorporates, or at least contemplated, SFAS-106 costs, and thus such costs should not

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<sup>70</sup> ETI at p. 9.

be recovered again through exogenous cost treatment.<sup>71</sup> MCI's consultant Drazen attempts to show through a discounted cash flow model that the anticipation of the adoption of SFAS-106 is already incorporated into LEC stock prices.<sup>72</sup>

The opposing parties are wrong in assuming that the latest Commission prescription of rate of return made the LECs whole, in total or in part, when it set rates for price cap LECs. First, they have ignored the reality that the LECs are regulated on their accounting records. In monitoring the company's books, the regulator must recognize any change in accounting rules that affects the company's earnings which is not otherwise accounted for and make an adjustment for the change. The regulatory agency, by setting a fair rate of return, has not obviated its requirement to compensate the company for any reasonable and necessary expenditures.

Second, the opposing parties ignore the link between risk and return. They simply and wrongly contend that a postulated change in the stock price of a company automatically implies a change in the cost of capital. Changes in the cost of capital are caused by changes in risk, not simply by a change in stock price. In fact, the Commission has stated that "(a)n increase in the price of a stock, however, may leave the stock's expected return unchanged if the price rose to adjust for higher anticipated

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<sup>71</sup> Ad Hoc at p. 17, fn. 45; ETI at p. 2, 11-12; MCI at pp. 11-17, and Appendix A.

<sup>72</sup> Drazen at pp. 2-7.

profits rather than lower investor perceived risk."<sup>73</sup>

The existence of post-employment medical liabilities is nothing new, certainly not to analysts and investors. Incorporation of these liabilities into the stock prices of companies was not affected by or based on the FASB pronouncement, but was economic reality all along. SFAS-106 merely affected the accounting of these costs and, potentially, the recovery through rates. If stock prices were reduced by these liabilities, it was not because of SFAS-106. If stock prices have been reduced by expectations, the need for exogenous treatment has not been eliminated.

While it is completely inappropriate to contend that an accounting issue such as this can be addressed through cost of capital, the specific issues brought forward by the opposing parties on cost of capital are addressed by the USTA Rebuttal. SWBT supports the USTA Rebuttal and incorporates by reference its arguments on these points.

The underlying weakness in all of the arguments that the cost of capital already contains a premium to account for SFAS-106 costs is quite straightforward. Any perceived stock price effects are caused by possible changes in dividend and earnings growth assumptions. The stock price effects do not materialize on their own, the two go hand-in-hand. Even Drazen acknowledged this linkage when he stated that "efficient markets theory argues that

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<sup>73</sup> Represcription the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, CC Docket No. 89-624 (FCC 90-315) (released December 7, 1990) at para. 133.

a future anticipated change in cost and hence earnings will be reflected in current stock prices."<sup>74</sup> The opposing parties have taken a postulated change in stock prices and imputed a change in cost of capital completely at odds with the literature they cited and with the Commission's own statements and in violation of their reliance on the DCF method to estimate the cost of equity.

III. OTHER CHALLENGES TO SWBT'S DIRECT CASE SHOULD BE REJECTED.

A. MCI's Concerns About The Level Of Detail Are Without Foundation.

MCI expresses concerns about the level of detail provided by the price cap LECs in the computation of SFAS-106 Costs, specifically requesting data on the TBO.<sup>75</sup> SWBT has already provided sufficient detail in this regard. In fact, SWBT has provided data detailing plan provisions, actuarial assumptions, expense detail, and calculation of exogenous adjustments. The level of detail provided by SWBT is substantial and sufficient to permit the review of the reasonableness of SWBT's estimates.

In response to MCI's request for additional data, SWBT's total company TBO is estimated to be \$2,736,795,000 and estimated 1993 SFAS-106 expense is \$426,502,000 (including \$171,037,000 for

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<sup>74</sup> Drazen at pp. 2-3.

<sup>75</sup> MCI at pp. 18-20. Drazen claims that the degree of uncertainty in the Warshawsky study means that the correct adjustment for the effects of SFAS-106 will similarly be quite uncertain. (Drazen at p. 7.) Fear of uncertainty, however, should not preclude or invalidate estimates as required by the FASB to reflect SFAS-106 expense. Instead, the Commission should focus on the reasonable safeguards built into the SFAS-106 standards to deal with the uncertainty that is inherent in any process of estimating.

TBO amortization). Should the Commission, MCI, or other parties have legitimate needs for additional SFAS-106 information, SWBT stands ready to provide such information.

B. The Godwins Study Correctly Analyses The Effect Of SFAS-106.

The oppositions argue to varying degrees that the Godwins study is flawed. AT&T attacks the Godwins study of the double count and argues, inter alia, that the 3 percent estimate of increased labor costs is incorrect, that the study does not allow for testing of the model and that the model itself is overly sensitive.<sup>76</sup> Ad Hoc contends that the Godwins model also does not accurately calculate the amount of double counting, that the model is flawed, and that a different model should have been used.<sup>77</sup> MCI further attempts to show that portions of the Godwins study are incorrect.<sup>78</sup>

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<sup>76</sup> AT&T at pp. 8-11.

<sup>77</sup> Ad Hoc at pp. 19-22.

<sup>78</sup> MCI at p. 20. MCI contends that the NERA study (relied upon by Pacific and Rochester) and the Godwins study are inherently contradictory and that neither model can be used to determining the amount of double counting in the GNP-PI. (MCI at pp. 21-23.)

MCI misunderstands the approach in the Godwins study that always selected conservative assumptions. Specifically, the Godwins view noted by MCI at p. 21, that prices will increase in the non-TELCO segment of the economy" is an assumption selected so that the effect of SFAS-106 on GNP-PI is intentionally overestimated. This results in an underestimate of the need for exogenous cost recovery, an approach that should give the Commission confidence in its ability to rely on the Godwins estimate. If MCI believes that this assumption utilized by Godwins is not representative of "the economic structure of the United States," (MCI at p. 22) then MCI reinforces the conservative nature of the Godwins estimate.

While SWBT utilized the Godwins study, it was also filed in this proceeding by USTA. USTA is filing its own Rebuttal in this docket. All challenges to the Godwins study that are not covered in this pleading are countered by the USTA Rebuttal which is incorporated herein by reference.

C. The Commission Should Not Mandate Uniform Assumptions.

AT&T argues that the LECs should use the following assumptions:

1. Medical expense plan, Medicare Part B premium reimbursements and dental care plan costs per employee capped as of January 1, 1993 levels. No "substantive plan" increases in benefits.<sup>79</sup>
2. A discount rate of 9%, a rate of return on plan assets of 9% and a health care trend rate (including inflation) of 10% in 1991, decreasing by 0.4% annually to 4% in 2006.<sup>80</sup>
3. A health care trend rate reduced by 4% to eliminate alleged "double count" effects.<sup>81</sup>

While AT&T suggests establishing uniform LEC benefit plan provisions and actuarial assumptions, SFAS-106 requires best estimates of future events. Many of those best estimates, such as the health care trend rate, are required to be established based upon each company's past experience. SWBT's actuarial assumptions used in the valuation accurately reflect its best judgment as to future trends based on SWBT's current circumstances and historical experience and in compliance with the objective guidance of the

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<sup>79</sup> AT&T at pp. 26-27.

<sup>80</sup> AT&T at p. 28.

<sup>81</sup> AT&T at p. 29. See also AT&T at Appendix F, p.13.

FASB in SFAS-106.

SWBT's own retiree benefit plan provisions exist as the result of bargaining contracts or internal management decisions. The plan is part of a total compensation package which enables SWBT to retain a quality work force, to operate efficiently and provide adequate return to shareowners.

Notwithstanding the above, SWBT's valuation does, in fact, assume a defined dollar cap on health benefits as of January 1, 1993 and federally-scheduled Medicare Part B reimbursements. No substantive plan increases are assumed to occur in subsequent years.

1. The Variation In OPEB Costs Between Companies Is Irrelevant.

In support of its argument to mandate uniform assumptions, AT&T claims there is a large variation in OPEB costs per employee, from a low of \$1,660 for BellSouth, to a high of \$4,658 for SWBT.<sup>82</sup> These figures, however, are irrelevant.

AT&T's analysis took each LECs' total company 1993 SFAS-106 liability, as filed in its Direct Case, reduced the liability in some cases by accumulated assets, and divided it by AT&T's estimate of the number of the LECs' total company active and retired employees that are pension eligible.<sup>83</sup> This analysis is directly affected by the level of funding by each company and, thus, contrary to AT&T's contention, does not accurately reflect a

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<sup>82</sup> AT&T at p. 22, fn. \*; Appendix E.

<sup>83</sup> AT&T at Appendix E, p. 1.

comparison of plan provisions among companies. Moreover, AT&T's analysis is incomplete, at least for SWBT, because it failed to identify the incremental expense above current OPEB claims.<sup>84</sup>

In contrast to some other price cap LECs, SWBT has done virtually no funding of the OPEB obligation to date. This minimal funding, which has been made only for OPEB life insurance benefits, resulted in a lesser return on funded assets and a greater SFAS-106 expense than for other LECs. It is invalid to compare SWBT's situation to companies that have extensively funded these obligations.<sup>85</sup>

As SWBT stated in its Direct Case,<sup>86</sup> other carriers' rates have included OPEB costs above pay-as-you-go levels on an accrual (funding) basis. SWBT has not included accrual accounting for OPEBs in its interstate rates. For the most part, those LECs that have funded are those LECs whose rates already include some recovery of accrual accounting for OPEBs above pay-as-you-go levels. The current request for exogenous treatment would merely equalize SWBT's rates with those of the LECs that previously funded or adopted modified accrual accounting for OPEBS prior to SFAS-106.

## 2. The Differences Cited By ETI Are Irrelevant.

ETI asserts that the actuarial studies show significant

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<sup>84</sup> See, SWBT Direct Case at Exhibit 3, p. 1.

<sup>85</sup> A comparison of the data submitted in the LEC Direct Cases illustrates the differences in levels of funding.

<sup>86</sup> SWBT Direct Case at pp. 13-14.

differences in factors.<sup>87</sup> Obviously there are differences in the LEC filings regarding plan provisions and actuarial assumptions because these companies are in fact unique entities that have different plans, have made different choices with respect to funding and have differences in their experienced health care cost increases, employee turnover, and mortality rates.

There is no particular value in forcing companies to use uniform data contrary to SFAS-106 when the actual data is, in fact, different on a company-by-company basis. Since SFAS-106 is consistent with Commission objectives, SFAS-106 and its methodology should be used instead of uniform data.

3. SWBT's Plan Assumptions Are Not Overly Generous.

AT&T claims that LEC differences in the level of SFAS-106 above pay-as-you-go levels may be due to generous plan assumptions.<sup>88</sup> AT&T's analysis of the LEC data that led to its conclusion is wrong. Section 1 above explains that the company-by-company comparisons presented by AT&T are flawed, at least with respect to SWBT.

Moreover, SWBT's Plan provisions and basic actuarial assumptions are reasonable and in accordance with FASB requirements in SFAS-106. The benefits and assumptions are not generous but reasonable in light of SWBT's circumstances and historical experience with these types of benefits.

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<sup>87</sup> ETI at p. 8, fn. 14, Table A.

<sup>88</sup> AT&T at p. 23, fn. \*\*; Appendix G.

SWBT's SFAS-106 amounts will be booked by SWBT and reported to the SEC and the external community at large and will be subject to audit by independent certified public accountants. This valuation reflects SWBT's best estimates of OPEB expense as calculated under SFAS-106.

4. Early Retirement Programs Are Included In SWBT Estimates.

ETI argues that recent early retirement programs have had an effect on LEC employee demographics which has not been included in LEC estimates.<sup>89</sup> Ad Hoc also asserts that many employees leave employment before receiving OPEBs, stating that, as a result, LECs could inflate PCIs to reflect future benefits never provided.<sup>90</sup>

Early retirement programs offered by SWBT have been taken into account in estimating SFAS-106 expense by altering the mix of active and retired employees. The actuarial assumptions on retirement rates are based on SWBT's past experience excluding the effects of early retirement programs because the recent large number of employee retirements is not representative of expected future retirement patterns. Absent this approach, SWBT's SFAS-106 costs would be higher.

Ad Hoc's critique does not apply to SWBT's valuation. Employee turnover is a basic actuarial assumption in SWBT's valuation. The turnover assumptions used by SWBT are based on SWBT's actual past experience. Accordingly, SWBT's estimated SFAS-

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<sup>89</sup> ETI at pp. 10-11.

<sup>90</sup> Ad Hoc at p. 14.