

106 expenses have been appropriately reduced for the fact that employees leave the company before OPEB benefits are vested.

5. SWBT Would Not Object To A Subsequent True-up Of The SFAS-106 Liability If Major Changes Occur.

MCI argues that subsequent filings would be necessary.⁹¹ In fact, SFAS-106 expense may be revised in subsequent years for plan amendments and/or changes in actuarial assumptions.

Present plan provisions are used in the actuarial valuation because these reflect best current estimates, but SWBT acknowledges that a major change, such as the introduction of a national health care insurance plan, would affect both SFAS-106 costs and pay-as-you-go costs. The effect of such a change, however, on the increment between SFAS-106 and pay-as-you-go is unclear. SWBT is willing, in a subsequent proceeding, to adjust the SFAS-106 exogenous amount if it can be demonstrated that the significant event (e.g., national health care insurance) would warrant an adjustment.

SWBT opposes MCI's suggestion that ARMIS or the Tariff Review Plan (TRP) be significantly altered to require annual tracking of SFAS-106 costs. The price cap LECs have requested exogenous treatment for the effects of the accounting change which is a one time event. MCI implies that the Commission needs to track ongoing OPEB costs, whereas the focus of exogenous cost treatment is only the incremental cost of SFAS-106. Thus, MCI's suggestion should not be adopted.

⁹¹ MCI at pp. 19-20.

IV. CONCLUSION

For the foregoing reasons, the Commission should recognize the change in accounting necessary for implementation of SFAS-106 as an exogenous cost change.

Respectfully submitted,

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Rebuttal of AT&T Suggestion to Subtract Overall Inflation

AT&T claims that inflation is included in the exogenous cost component and in the GNP-PI and that the LECs have not effectively removed this double count. (AT&T, p.7) AT&T states that "to fix the 'double counting' the FCC should require that the expected change in the GNP-PI be subtracted from the health care inflation component of the SFAS-106 accrual." (AT&T, p.13)

AT&T mistakenly assumes that general inflation affects present value calculations, like the calculation used in the SFAS-106 valuation. Present value calculations, however, are always purged of expected general inflation. Exogenous cost treatment of the incremental costs imposed by SFAS-106 adoption will not result in double counting of medical care inflation in the price cap formula. The following analysis illustrates this flaw in AT&T's recommendation.

In the calculation of the SFAS 106 accrual amount, denoted here as A, future nominal OPEB costs are discounted at a nominal long-term rate of interest, denoted r, to arrive at their present value:

$$(1) \quad A = \sum_{t=1}^n \frac{B_t}{(1+r)^t}$$

B_t represents the level of benefit payments expected in period t and there are n periods of benefit obligations.

For purposes on this exposition only, a constant medical care inflation and no change in medical plan utilization is assumed. In this case, the SFAS 106 accrual can be written as:

$$(2) \quad A = \sum_{t=1}^n \frac{B_0 (1+m)^t}{(1+r)^t}$$

B_0 is the initial level of benefit payments and m is the rate of medical care inflation.

AT&T asserts that medical care inflation "includes general inflation plus influences that are specific to the health care sector" (AT&T, p.13, fn. **). Southwestern Bell agrees that medical care inflation can be split between overall inflation and the increment due to increases in the real cost of medical care, as follows:

$$(3) \quad 1 + m = (1 + p)(1 + m_r) \\ = 1 + p + m_r + pm_r$$

Here p is the expected rate of inflation in the total GNP-PI, and m_r represents the expected rate of increase in the cost of medical care relative to the total GNP-PI¹, or the expected increase in the real cost of medical care.

Substituting $(1 + p)(1 + m_r)$ for the expected rate of medical inflation splits medical care inflation into expected general inflation and expected increases in the real cost of medical care. In a similar manner, the nominal discount rate can be split into a real rate of interest r , and the expected general rate of inflation, as follows:²

$$(4) \quad 1 + r = (1 + r_r)(1 + p)$$

Using equations (3) and (4) to substitute for the terms in (2) yields:

$$(5) \quad A = \sum_{t=1}^n \frac{B_0 (1 + p)^t (1 + m_r)^t}{(1 + r_r)^t (1 + p)^t} \\ = \sum_{t=1}^n \frac{B_0 (1 + m_r)^t}{(1 + r_r)^t}$$

¹ The interaction term pm_r , on the second line of equation (3) is usually numerically small.

² This relationship is often called the Fisher equation after Irving Fisher. See Irving Fisher, Theory of Interest (1930, New York: McMillan) for his definitive work on this subject. This relationship is usually written in the simpler additive form as: $r = r_r + p$. The multiplicative form used above includes the interaction term $r_r p$. The Fisher equation is standard material in economics and finance textbooks. See, as an example, Eugene F. Brigham, Financial Management: Theory and Practice, 4th ed., (1985, Chicago: The Dryden Press), pp. 204-205.

This analysis illustrates that the expected rate of general inflation, including the contribution to general inflation due to growth in the medical care component, is completely canceled out of the calculation of the SFAS-106 accrual. Said differently, present values are always expressed in the dollars of the initial year. Expected general inflation does not add to the value of the accrual. To contend that it does is wrong. The SFAS-106 accrual is equal to the present value of future real OPEB payments. Moreover, it is unnecessary to compute m_r and r , separately, because the result in equation (5) falls out of the simple application of equation (2).

Thus, the SFAS-106 accrual is unaffected by inflation in the total GNP-PI.

The "correction" proposed by AT&T is equivalent to dividing the numerator of equation (5) by $(1 + p)^t$ in addition to discounting the benefit amounts by the nominal rate of interest.³ Thus, AT&T recommends that the following modified version of the SFAS-106 accrual be used as the basis for the exogenous adjustment:

$$(6) \quad A_{AT\&T} = \sum_{t=1}^n \frac{B_0 (1 + p)^t (1 + m_r)^t}{(1 + r_r)^t (1 + p)^t (1 + p)^t}$$

$$(7) \quad = \sum_{t=1}^n \frac{B_0 (1 + m_r)^t}{(1 + r_r)^t (1 + p)^t}$$

The benefit payments in the numerator of equation (7) are in constant dollars, yet AT&T incorrectly proposes to discount these real payments at the nominal rate of interest. As equation (6) clearly shows, this is equivalent to discounting a flow of nominal payments at a rate that doubles the premium for the expected rate of inflation. To do so is clearly incorrect.

³ AT&T ignores the interaction term pm_r on the second line of equation (3). Hence, AT&T recommends subtracting p from m_r , rather than dividing $1 + m_r$ by $1 + p$.

CERTIFICATE OF SERVICE

I, Lisa Jundt, hereby certify that the foregoing "Rebuttal of Southwestern Bell Telephone Company" in Docket # 92-101, Transmittal Nos. 497, 246, 1579 has been served this 31st day of July to the Parties of Record.


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