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July 31, 1992

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

Donna R. Searcy  
Secretary  
Federal Communications Commission  
1919 M Street, N.W., Room 222  
Washington, D.C. 20554

Dear Ms Searcy:

Re: *CC Docket No. 92-101 - Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions"*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of its "*Rebuttal To Oppositions To Their Direct Case*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,



Enclosures

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JUL 31 1992

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Treatment of Local Exchange	)	CC Docket No. 92-101
Carrier Tariffs Implementing	)	
Statement of Financial Accounting	)	
Standards, "Employers Accounting	)	
for Postretirement Benefits Other	)	
Than Pensions"	)	
	)	
Bell Atlantic Tariff F.C.C. No. 1	)	Transmittal No. 497
	)	
US West Communications, Inc. Tariff	)	Transmittal No. 246
F.C.C. Nos. 1 and 4	)	
	)	
Pacific Bell Tariff F.C.C. No. 128	)	Transmittal No. 1579
	)	
	)	

REBUTTAL OF PACIFIC BELL AND NEVADA BELL  
TO OPPOSITIONS TO THEIR DIRECT CASE

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Date: July 31, 1992

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## SUMMARY

Price cap LECs should be permitted to increase their price cap index levels as a result of their implementation of Statement of Financial Accounting Standards 106 (SFAS 106). SFAS 106 meets all of the criteria for an exogenous event stated in the Commission's rules and orders. It triggers costs which are beyond the control of the carriers. It is also, except to a small degree (for which Pacific Bell accounted in its tariff), not reflected in the GNP-PI. If the SFAS 106 accrual is not reflected in carriers' current rates, it will unfairly penalize the carriers' investors, or burden future ratepayers with current costs, or both.

The parties opposing the Pacific Companies' direct case have failed to demonstrate that SFAS 106 costs should not be recovered as the Pacific Companies propose. The parties who contend that SFAS 106 costs are not exogenous do not understand the Commission's price cap rules and orders. SFAS 106 costs are triggered by an administrative action that is beyond the control of carriers. The fact that carriers might have some control over the level of these costs does not mean they are not exogenous or that cost recovery should not be allowed. Some parties contend that under price cap regulation SFAS 106 costs will be recovered through changes to the GNP-PI, or that they have already been

reflected in the rate of return prescribed by the Commission. These arguments are fallacious. Finally, the way the Pacific Companies calculated the SFAS 106 accrual is reasonable and should not be reduced or compared to arbitrary benchmarks. The Pacific Companies should be permitted to make an exogenous adjustment to their price cap indices. Pacific Bell's tariff should be permitted to take effect on January 1, 1993, as filed.

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	)	
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	)	
	)	

REBUTTAL OF PACIFIC BELL AND NEVADA BELL  
TO OPPOSITIONS TO THEIR DIRECT CASE

Pursuant to the Order of Investigation and Suspension released by the Common Carrier Bureau (the "Bureau") on April 30, 1992,<sup>1</sup> Pacific Bell and Nevada Bell (the "Pacific Companies") submit this Rebuttal to oppositions to their Direct

<sup>1</sup> Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions", Bell Atlantic Tariff F.C.C. No. 1, US West Communications, Inc. Tariff F.C.C. Nos. 1 and 4, Pacific Bell Tariff F.C.C. No. 128, CC Docket No. 92-101, Order of Investigation and Suspension, DA 92-540, released April 30, 1992.

Case in the above-captioned proceeding. Oppositions were filed by AT&T, MCI Communications Corp. ("MCI"), the Ad Hoc Telecommunications Users Committee ("Ad Hoc"), the International Communications Association ("ICA").<sup>2</sup> These parties have failed to demonstrate that the change in accounting necessary for implementation of Statement of Financial Accounting Standards No. 106 (SFAS 106) should not be recognized as an exogenous cost change under the Commission's price cap rules. The revisions in Pacific Bell's Transmittal No. 1579, filed April 16, 1992, have been sufficiently justified and should be permitted to take effect as filed.

I. IMPLEMENTATION OF SFAS 106 RESULTS IN A RECOVERABLE COST CHANGE UNDER THE PRICE CAP RULES.

Ad Hoc, MCI, and ICA argue that the implementation of SFAS 106 does not result in a recoverable cost change under the price cap rules.<sup>3</sup> Their arguments fall into three general categories: (1) SFAS 106 costs are not exogenous; (2) some or all SFAS 106 costs are recovered in current rates or will be recovered through future changes to the GNP-PI, so that an exogenous cost adjustment would result in double recovery; and

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<sup>2</sup> Ad Hoc and ICA support their Oppositions with the same study by Economics and Technology, Inc. ("ETI Study").

<sup>3</sup> AT&T does not contend that SFAS-106 costs are not exogenous, but does argue that an exogenous adjustment would lead to some double recovery. AT&T, pp. 5-14.

(3) even if SFAS 106 costs are exogenous and will not otherwise be recovered, under the price cap rules carriers should bear the costs of SFAS 106. These arguments have no merit.

A. Background.

According to the Commission, "[e]xogenous costs are in general those costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers."<sup>4</sup> Exogenous costs should be recoverable under price cap regulation to the extent they are not already reflected in the GNP-PI.<sup>5</sup> "These are costs that should result in an adjustment to the [price] cap in order to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates."<sup>6</sup>

The National Economic Research Associates (NERA) Study, submitted with the Pacific Companies' Direct Case, determined the following. First, adoption of accrual accounting for postretirement benefits represents an accounting recognition of proper economic costs. 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. Second, adoption of SFAS 106

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<sup>4</sup> Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6807 (para. 166) (1990) ("LEC Price Cap Order").

<sup>5</sup> See Policy and Rules Concerning Rates for Dominant Carriers, 6 FCC Rcd 2637, 2665 (para. 63) (1991) ("LEC Price Cap Reconsideration Order").

<sup>6</sup> LEC Price Cap Order, 5 FCC Rcd at 6807 (para. 166).

accounting by the FASB and by the FCC is beyond the control of price cap carriers. Moreover, a one-time adjustment to its prices to move from a cash to an accrual basis in order to reflect the economic costs of postretirement benefits does not reduce a carrier's incentive to control expenditures on those benefits. Third, because prices in unregulated markets already reflect economic costs, including those associated with postretirement benefits, adoption of SFAS 106 will not cause them to change. Hence, the effect of SFAS 106 on output prices is confined to the cost plus sector, and the estimated effect on the rate of growth of GNP-PI is less than 0.12% per year.

Carriers must be allowed to reflect the incremental costs of SFAS 106 in rates or the Commission's policies will be undermined. SFAS 106 mandates that the costs of postretirement benefits other than pensions (OPEB) be recognized for financial reporting purposes on an accrual, rather than a cash basis. SFAS 106 furthers a fundamental premise of GAAP, namely, that accrual accounting reflects the true economic cost of postretirement benefits which cash basis accounting does not. The Pacific Companies' initial price cap rates were based on cash accounting for OPEB. Cash accounting of OPEB is seriously flawed for ratemaking purposes because it does not properly match cost recovery to the period in which services are provided; it causes a generational inequity. If the incurred costs of OPEB are not reflected in the price of services today, they will either have

to be recovered from future generations of ratepayers to whom they are not really attributable, or they will have to be absorbed by the Pacific Companies' shareholders. In either case, the economic costs of OPEB will not be recovered from the cost-causers. Accrual accounting properly allocates OPEB costs to the periods in which they are earned. If SFAS 106 costs are not recognized for ratemaking purposes, efficiency will be discouraged because rates will not be based on economic costs. Future ratepayers will be burdened with costs attributable to current ratepayers.

B. Adoption of SFAS 106 Results In An Exogenous Increase in Costs.

None of the parties opposing the Pacific Companies' Direct Case contends that the adoption or implementation of SFAS 106 was not outside the control of carriers. What some parties do argue is that because carriers control OPEB costs, the costs are not exogenous and should not be recoverable. By "control", they mean that the carriers can reduce the level of these costs; no party seriously contends that OPEB costs can be eliminated.

The way these parties would define an exogenous cost change is a plain distortion of the Commission's definition. The Commission defines exogenous costs as those which are "triggered by administrative, legislative or judicial action beyond the control of the carriers."<sup>7</sup> That carriers may be able to

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<sup>7</sup> LEC Price Cap Order, 5 FCC Rcd at 6807 (emphasis added).

control these exogenous costs after they are triggered does not mean that the costs should not be recovered. The opposing parties' distorted definition has no support in the price cap rules or in any of the Commission's decisions. If their standard were applied across the board, the carriers would be allowed to recover virtually none of their exogenous costs, because they can nearly all be "controlled" to some extent. This directly contradicts all principles of ratemaking. In its price cap decisions the Commission recognized that carriers can control costs and encouraged it, not by denying all recovery of "controllable" costs but through mandatory productivity adjustments and the ability to share in additional productivity savings.

Ad Hoc states most succinctly:

A carrier must show that an exogenous cost change was specified by the Commission or other governmental action and thus beyond its control. The carrier must further demonstrate that it is not able to control or influence the amount or extent of the cost changes purportedly attributable to the governmental action.

Ad Hoc, pp. 7-8. Although Ad Hoc cites two Commission decisions in support of the second sentence quoted above, neither decision supports the general principle that Ad Hoc asserts. It amounts to a misrepresentation.

In the first decision that Ad Hoc cites, the Common Carrier Bureau denied AT&T's attempt to recover SFAS 106 costs as an exogenous change before FASB adopted SFAS 106. The Bureau held that "[a]lthough the accounting change AT&T seeks to claim

as exogenous will probably be mandated by FASB in 1992, and at that time qualify for exogenous treatment, AT&T's decision to implement this change before any change is mandated by FASB or this Commission's accounting rules does not result in a cost change that can be treated as exogenous."<sup>8</sup> This does not support Ad Hoc at all; it supports the local exchange carriers. SFAS 106 was not mandatory then. It is mandatory now, and accordingly, as the Bureau observed, it ought to qualify for exogenous treatment.<sup>9</sup>

The paragraphs of the LEC Price Cap Order that Ad Hoc cites deny exogenous treatment for depreciation rate changes.<sup>10</sup> The comparison with the proposed one-time adjustment to adopt SFAS 106 does not stand up to scrutiny. The Commission denied exogenous treatment for changes in depreciation rates because although the Commission prescribes the rate, the carrier

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<sup>8</sup> AT&T, 5 FCC Rcd 3680 (1990) (emphasis added).

<sup>9</sup> If the Bureau decides that OPEB accruals are not recoverable in rates it will, of course, have to explain the inconsistency with its observation two years ago. See AT&T v. FCC, 836 F.2d 1386, 1392-93 (D.C. Cir. 1988) ("to the extent that [the Commission] is 'changing its course[, it] must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored . . .'" 836 F.2d at 1392-93 (quoting Greater Boston Television Corp. v. FCC, 444 F.2d 841, 852 (D.C. Cir. 1970), cert. denied, 403 U.S. 923 (1971))). See also I.N.S. v. Cardoza-Fonseca, 480 U.S. 421, 446 n.30 (1987) ("An agency interpretation of a relevant provision which conflicts with the agency's earlier interpretation is 'entitled to considerably less deference' than a consistently held agency view").

<sup>10</sup> LEC Price Cap Order, 5 FCC Rcd at 6809 (paras. 182-83).

determines the life of the plant to which the rate is applied.<sup>11</sup> Ad Hoc's analogy between OPEB and depreciation rates is obviously false.

The change with respect to SFAS 106 expenses is a change in the methodology required by the FASB and adopted by the Commission. It is not similar to a change in the life of the plant which is decided upon by the carrier. The Commission has recognized that when it imposes a change in methodology, exogenous treatment of the costs is appropriate. For example, the Commission treated the amortization of the Reserve Imbalance Correction ("RIC") as exogenous,<sup>12</sup> noting that the need to amortize depreciation reserve deficiencies resulted from the Commission's past methods of calculating depreciation expense.

In the instant case, the Transition Benefit Obligation related to OPEB also results from the Commission's prior requirement that such benefits be reflected at the time they were paid. The liability was created by past Commission practices. Now the Commission has adopted SFAS 106 accrual methodology for accounting purposes. It is consistent with past regulatory policy that the change to the new OPEB methodology be treated as exogenous just as the reserve imbalance was treated. Likewise

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<sup>11</sup> Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 3015 (para. 290) (1989) ("Second Further Notice").

<sup>12</sup> LEC Price Cap Order, 5 FCC Rcd 6786 (para. 185).

subsequent OPEB accruals should be treated as endogenous just as the Commission ordered depreciation accruals to be treated.<sup>13</sup>

The LEC Price Cap Order in no way supports Ad Hoc's claim that a carrier "must demonstrate that it is not able to control or influence the amount or extent of the cost changes" triggered by the exogenous event. The rule that Ad Hoc infers from that decision is imaginary.

Ad Hoc also (p. 14) cites the Commission's denial of exogenous cost treatment for equal access costs. In that case the Commission stated two principal reasons for denying exogenous treatment. First, the largest carriers had nearly completed equal access conversion and thus its costs were already embedded in their rates. Small carriers could remain under rate of return regulation and recover any projected conversion costs in their annual rate of return filings. Second, the Commission observed that it would be difficult to distinguish equal access costs from other switched access costs.<sup>14</sup> Neither reason holds in the case of SFAS 106 costs. Some OPEB costs are already embedded in Pacific Bell's rates, but Pacific Bell removed these costs from its tariff filing and seeks exogenous treatment only for the incremental OPEB costs resulting from the change from cash to

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<sup>13</sup> Id. at para. 182.

<sup>14</sup> LEC Price Cap Order, 5 FCC Rcd at 6808 (para. 180).

accrual accounting. And unlike equal access conversion costs, OPEB costs are easily distinguished from other types of costs.

A better comparison to SFAS 106 than the two misleading examples that Ad Hoc suggests would be a change in the separations manual or the uniform system of accounts (USOA). Although carriers have some control over the amount of their regulated costs, they do not control the recognition of those costs for accounting or separations purposes. Changes in the Separations Manual and the USOA are thus "truly exogenous cost factors."<sup>15</sup> If they "trigger" incremental changes in the recognition of costs, the changes are recoverable through an exogenous adjustment. That the carriers might be able to "influence" these costs (Ad Hoc, p. 13) after they are triggered not only is irrelevant to whether they are truly exogenous, it is one of the aims of price cap regulation to control such costs.

MCI labors under similar misunderstandings. MCI says that:

While [their] lack of control over the FASB ruling is apparent, the LECs make no case as to why the effect of SFAS 106 is exogenous, and outside of their control. In fact, SFAS 106 is nothing more than an accounting change that alters the temporal recognition of costs on financial statements. It does not, by itself, alter the underlying costs of providing telephone service, but rather formally recognizes costs already being incurred by the LECs.

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<sup>15</sup> Second Further Notice, 4 FCC Rcd at 3016 (para. 290).

MCI, p. 8. Of course, this also describes changes in the USOA and the separations manual, changes the Commission has recognized as classic examples of exogenous events.<sup>16</sup> MCI is correct that SFAS 106 does not alter underlying costs, but forces recognition of economic costs at the time they are incurred. That is why the costs should be recovered. Postponing the recovery of these costs any longer would unfairly penalize investors and result in a serious generational inequity. Future ratepayers should not be burdened with costs that are being incurred and should be recovered now.

C. Recovering SFAS 106 Costs Is Consistent With Price Cap Regulation.

Price cap regulation is intended to reduce costs and improve efficiency with a stick (the annual productivity offset) and a carrot (the ability of carriers to retain or share excess earnings). The Commission intended price cap regulation to "reward companies that become more productive and efficient." Carriers are encouraged to reduce their costs or "inputs" by annual productivity adjustments and sharing of earnings that result from any productivity gains that exceed the adjustments.<sup>17</sup> It is intended to encourage carriers to reduce

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<sup>16</sup> Id.

<sup>17</sup> See LEC Price Cap Order, 5 FCC Rcd at 6787, 6790 (para. 31).

costs that are within their control, including costs triggered by exogenous events, not just make the carriers absorb them.<sup>18</sup>

"Regulatory decisions that are designed to produce just and reasonable rates must affect the cap in order to ensure that the system results in rates that are just and reasonable."<sup>19</sup>

All of the parties opposing an exogenous adjustment for OPEB costs seem to believe that the carriers' ability to influence the costs triggered by SFAS 106 not only disqualifies those costs for exogenous treatment, but would make recovery of any such costs unfair and contrary to price cap principles. The first argument these parties make is that if OPEB costs are recovered through an exogenous adjustment, carriers will have no incentive to reduce costs but will be overgenerous in the OPEB they provide. This is demonstrably untrue.

Second (and contrary to the first argument), these parties assert that if carriers do receive an exogenous adjustment they will reduce OPEB and will enjoy an unjustified windfall. This is also untrue. SFAS 106 is specific about the way that OPEB costs must be accrued. The Pacific Companies' accrual of OPEB costs is reasonable, as shown in Section II

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<sup>18</sup> See Second Further Notice, 4 FCC Rcd at 3215-16 (para. 708).

<sup>19</sup> LEC Price Cap Order, 5 FCC Rcd at 6807. See also Second Further Notice, 4 FCC Rcd at 2924-25 (para. 106).

below. The accrual is also subject to oversight by external auditors and securities regulators. The Pacific Companies' ability to subsequently reduce OPEB costs is much more limited than these parties suggest, but if they are subsequently reduced, (or increased) under price cap regulation those changes must be treated endogenously, just as other expenses are treated.

Third, some parties argue that the balance of price cap regulation will be upset unless carriers simply absorb the exogenous costs created by the change from cash to accrual accounting. This too is false, as evidenced by the Commission's own orders and by judicial precedent holding that carriers are entitled to recover legitimate operating expenses.

Ad Hoc's and MCI's assertions that exogenous treatment for OPEB would reduce cost control incentives (Ad Hoc, p. 16; MCI, p. 23, n.27) are flat out wrong. The Pacific Companies' incentives to reduce OPEB costs are identical to their incentives to reduce other forms of labor compensation such as wages and pensions that were already included in their rates before price caps. The incentive to reduce OPEB costs is no greater if carriers are not permitted to recover the costs, as MCI contends (id.). The incentive to reduce costs remains the same no matter how much a carrier earns.

MCI makes a related argument, based on its belief that carriers are proposing "asymmetrical" treatment of OPEB costs and

other labor costs. The belief is based on a serious misunderstanding. MCI says:

A firm will generally decide upon the total amount of compensation it is willing to offer its employees, and has great latitude in mixing the components of the package (cash wages, OPEB, pensions, current benefits, etc.). If exogenous treatment is afforded to one portion of the compensation package, an asymmetrical relationship will be afforded carriers under price caps. This will allow carriers to offer increased OPEB, for which they would receive exogenous treatment, and decrease other forms of compensation. This latter decrease will allow carriers to increase the earnings they could potentially keep under the price cap sharing rules.

MCI, p. 6. This assertion has a false premise, which appears on p. 7 of MCI's Opposition: "Both sets of rules, SFAS 106 as well as the price cap rules would require these carriers to re-estimate their liabilities under SFAS 106 and to flow these changes through to their price cap indices in true-up filings."

MCI, p. 7. The statement is puzzling and wrong. In its tariff filing Pacific Bell seeks a one-time adjustment to the price cap index.<sup>20</sup> Any increases in OPEB costs thereafter would be

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<sup>20</sup> Pacific Bell Transmittal No. 1579, Description and Justification, p. 3. Ad Hoc appears to be operating under the same assumption as MCI. Ad Hoc says that "[e]xogenous cost treatment of SFAS-106 implementation would also likely require the Commission to resolve numerous disputes regarding the actuarial and demographic assumptions underlying carriers' PCI adjustments." Ad Hoc, p. 16. This would be true of almost every above-cap tariff filing that a carrier makes. It states no reason not to afford exogenous treatment to SFAS-106 costs.

absorbed endogenously and would actually reduce earnings. Pacific Bell stated outright in its tariff filing that it "will not seek further exogenous rate increases if its actual OPEB costs exceed its projected OPEB costs."<sup>21</sup> Once it is understood that no "true-up filings" are required or contemplated, MCI's "asymmetrical treatment" argument makes no sense, though it goes on for several pages in the same misguided vein.<sup>22</sup>

MCI's repeated assertions that exogenous treatment of SFAS 106 costs "would defeat the stated goals of achieving efficiency under price caps, and would mark a return to the experience of rate of return regulation" (MCI, p. 9) therefore have no rational basis. The incentives that carriers have to decrease OPEB and other labor expenses are equal, as are the disincentives to increase those expenses. Annual reductions in the price cap index are forced on the carrier by the productivity offset. If the carrier's cost reductions do not match this offset, its earnings suffer. Conversely, the price cap rules provide an incentive for reductions to exceed the offset by letting carriers retain a share of excess earnings. The

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<sup>21</sup> Pacific Bell Transmittal No. 1579, Description and Justification, p. 5.

<sup>22</sup> This unexplainable error infects MCI's whole argument. MCI reiterates it at pp. 9-10 of its Opposition, when it attacks the USTA study because it "addresses a one-time shift, not the continuing ability of the LECs to trigger exogenous SFAS-106 costs." See also MCI, p. 11, n.14.

Commission does not disturb this balance one iota by allowing carriers to make a one-time adjustment for legitimately incurred costs that are triggered by events they do not control.

AT&T, itself subject to price cap regulation, ought to understand this principle but apparently does not. AT&T notes "the measure of control that LECs have over their actual OPEB expense levels," and complains that "a LEC could choose not to curtail its OPEB program (because expense recovery is assured), but could instead limit future wage and salary increases which are treated endogenously." AT&T, pp. 24-25. For the same reason, AT&T contends that only OPEB costs that have actually been prefunded should be considered for exogenous treatment "because there are no requirements ... that would prevent a carrier from recovering SFAS 106 accrual costs and in the future reducing the actual benefits paid. In fact, there is no requirement that these funds ever be used to pay OPEB costs at all." AT&T, pp. 14-15.

These contentions are flawed as well as inconsistent. Recovery of OPEB expenses is not "assured" by a one-time exogenous adjustment. Contrary to what AT&T suggests, such an adjustment would not remove the incentive to curtail OPEB costs, because the savings could be retained as earnings instead of being paid out as benefits. An adjustment would place OPEB expenses and other labor expenses on the same footing, with the same incentive for the carrier to control both. That is what distinguishes price cap regulation from rate of return regulation.

It is untrue, as AT&T implies, that revenues from an exogenous change might not be used to pay OPEB costs at all or that prefunding is necessary to assure that OPEB costs will actually be paid. The Pacific Companies' OPEB liabilities are real -- that is why SFAS 106 requires them to be accrued. AT&T's contention that they might be withdrawn at any time is also unrealistic. SFAS 106 recognizes that benefits have already been earned by current employees for services rendered up to the present and by the retirees while they worked for the carriers. Carriers do not have the unilateral ability to reduce or eliminate such benefits. Their ability to reduce benefits is highly constrained by legal obligations and collective bargaining with their employees.<sup>23</sup>

OPEB expenses are also interrelated, as MCI notes (MCI, p. 6), with other forms of compensation. Carriers, like other firms, compete for skilled employees. It is unlikely they could succeed in reducing OPEB expenses below what similar firms offer their employees, without having to make offsetting increases in other types of compensation. Finally, Pacific Bell's estimate of OPEB expenses assumes that employees will bear a significant portion of future inflation in medical costs.<sup>24</sup> Even if the

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<sup>23</sup> See below, p. 44.

<sup>24</sup> Direct Case of Pacific Bell and Nevada Bell, p. 18.

Pacific Companies bargain this issue aggressively with their employees, history suggests OPEB costs are more likely to increase than decrease over Pacific Bell's projection.

MCI makes essentially the same point as AT&T when it asserts that "LECs and their shareholders would enjoy a windfall gain of cash if exogenous treatment were given to SFAS 106 costs." MCI, p. 10. As shown in Pacific Bell's tariff filing,<sup>25</sup> revenues from the exogenous adjustment would be used to fund VEBA trusts to the limit of tax deductibility. The annual interest income from these VEBA trusts (some of it tax free) was also taken into account in Pacific Bell's accrual calculation. Moreover, the Commission's rules currently require that any unfunded OPEB liability would be treated as a rate base reduction. Thus the Pacific Companies would not "have use of large amounts of funds" (MCI, p. 10) for non-OPEB purposes, nor would they have the discretion never to pay OPEB costs at all as AT&T implies (AT&T, p. 15). Hence there is neither a need to " earmark" funds as MCI suggests (MCI, p. 11, n.14) nor to restrict cost recovery to prefunded amounts as AT&T recommends (id.).

MCI, Ad Hoc, and ICA argue that the Commission can disregard the effect that OPEB costs will have on carriers' earnings if they are not recovered in rates. Ad Hoc (ETI Report, p. 7) and ICA (id.) contend that SFAS 106 costs should not be

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<sup>25</sup> Pacific Bell Transmittal No. 1579, Description and Justification, Work Paper 1, p. 3 of 3.

reflected in rates unless the carriers can show that non-recovery would lead to confiscation. They assert that confiscation is the standard "under either price caps regulation or traditional rate base regulation." ETI Report, p. 7 (emphasis in original). They are wrong. When the Commission declined in the LEC Price Cap Order to revisit its decision permitting some carriers (including Pacific Bell) to recover certain prefunded OPEB costs in their last annual access charge filing under rate of return regulation, it stated:

Under the rate of return regulatory structure, as long as the carrier's costs are reasonable and prudent, those costs can be used in the ratemaking process to justify rates.

Our change in regulation, from rate of return to price caps, should not result in our changing the treatment of such costs. While a regulatory change may affect prospective treatment of these expenses, costs and rates that have been accepted as reasonable and prudent under prior standards should not be treated as unreasonable or imprudent merely because our regulations have changed.... removal now of already-accrued OPEB expenses from initial price cap rates would ..<sup>26</sup> redefine "reasonable" after the fact.

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<sup>26</sup> LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2665 (paras. 61-62) (emphasis added).

The Commission has never stated that recovery of reasonable and prudent expenses (which it found OPEB to be, above) is inappropriate unless confiscation would result. Price cap regulation has not pushed aside decades of judicial precedent holding that a utility should be permitted to recover all reasonable and prudent expenses.<sup>27</sup> Regulatory agencies must "give heed to all legitimate expenses that will be charges upon income during the term of regulation."<sup>28</sup>

In adopting price cap regulation, the Commission declined to treat "all extraordinary costs as exogenous", but because of the "Constitutional ban on confiscatory rates," it left "open the possibility that, in a truly extraordinary situation, [it] would waive part of the extensive showing required to justify above-cap rates."<sup>29</sup> For that same Constitutional reason the Commission indicated that rate

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<sup>27</sup> See West Ohio Gas Co. v. Public Utils. Comm'n, 294 U.S. 63, 74 (1935); Mountain States Telephone v. FCC, 939 F.2d 1021, 1029 (D.C. Cir. 1991); Illinois Bell, *supra*; AT&T v. FCC, 836 F.2d 1386, 1388 (D.C. Cir. 1988); Nader v. FCC, 520 F.2d 182, 204 (D.C. Cir. 1975); Mississippi River Fuel v. FPC, 163 F.2d 433, 437 (D.C. Cir. 1947).

<sup>28</sup> 294 U.S. at 74.

<sup>29</sup> Second Further Notice, 4 FCC Rcd at 3020 (para. 303). See also LEC Price Cap Order, 5 FCC Rcd at 6810 ("even perhaps without suspension and investigation").